

# **The Indian Real Estate Market: A Comprehensive Analysis for the Foreign Investor**

by  
**Sameer Nayar**

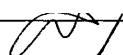
**Bachelor of Architecture, 1993  
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**Submitted to the Department of Architecture  
in partial fulfillment of the requirements of the Degree  
of  
Master of Science in Real Estate Development  
at the  
Massachusetts Institute of Technology  
September 1996**

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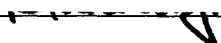
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**Interdepartmental Degree Program in Real Estate Development**

**MASSACHUSETTS INSTITUTE  
OF TECHNOLOGY**

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## **ABSTRACT**

In the post liberalization and the free market era, the Indian economy is buoyant and closely linked to hard currency transfers and transactions. The inflow of capital into various industries has risen several fold in the last five years. The related effects of these inflows on urban growth have been significant. The real estate markets in the country have been booming for the past 4-5 years. Along with the huge price increases in the major cities, suburban developments are also on the rise and the smaller cities are beginning to see large scale developments come on line. This has been due to a high demand base as well as certain archaic laws governing the real estate sector. Reforms in the real estate sector have been hard to come by, but there is now a consensus in terms of changing the restrictive laws.

Although the returns are extremely high in all sectors of the industry, the markets are very disorganized and lack the institutionality as witnessed elsewhere in the developed world. They can present considerable risks for the uninformed investor. The demand-supply relationship is skewed due to highly constrained land markets, lack of institutional financing, archaic and difficult regulations and an extremely painful construction process. Although not completely open to the foreign investors, the market presents a tremendous opportunity. There are a number of avenues available to the foreign investors for entering the market, some being more transparent and open than others. After analysing the market it seems imperative for the prudent foreign investor to look for an honest local joint venture partner, bring value added components like design and construction technology to the table, have a long term growth oriented vision, have a local office, be aware of the changing legal environment governing the real estate sector and finally go for the most transparent legal avenue available for entering the market.

Thesis Advisor: Blake Eagle

Title: Chairman, Center for Real Estate/MIT

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## Acknowledgment

I am grateful to Boston Financial and the Pioneer Group for providing the financial support to carry out this research. I am also indebted to all the people I interviewed, who took time off their busy schedules to talk to me. This thesis would not have been possible without their cooperation.

I would like to thank Blake Eagle for his guidance, encouragement and sense of humor throughout the thesis process. His international perspective to real estate clarified my thinking process.

Finally, I would like to thank my wife, Archana, for her unflinching support throughout the last year, and for impressing upon me, the importance of education in the quest for success.

## Chapter One

### *Introduction*

In the post liberalization and the free market era, the Indian economy is buoyant and closely linked to hard currency transfers transactions. The inflow of capital into various industries has risen several fold in the last five years. India is increasingly being spoken as the region of opportunity for the coming century. Given the remarkable economic growth rates, a huge population base, a rapidly growing middle class and a tremendous amount of cheap labor and resources, US and other western multinationals are rushing to India to establish new ventures and tap into the rapidly expanding market.

The related effects of these large scale investments, on urban growth have been significant. The real estate markets in the country have been booming for the past 4-5 years. This has been due to a high demand base as well as certain archaic laws governing the real estate sector. The US real estate industry has been slow to react to these emerging opportunities. Now there seems to be an increased interest in the industry to find out about the Indian real estate market. This is driven partly by American multinationals who have set up shop in India and are demanding the international level of real estate services, and on the other hand by investors who are getting interested due to the high level of returns being offered by the market. Mr. Dinesh Chandiok, Managing Director, Richard Ellis, views India as a much safer bet from an investment standpoint due to well protected property rights, a sophisticated financial system, tremendous demand base and an activity in the market which is not being witnessed in any other emerging market.<sup>1</sup>

Although the returns are extremely high, the markets are very disorganized and lack the institutionality as witnessed elsewhere in the developed world and can present considerable risks for the uninformed investor. The demand-supply relationship is skewed due to highly constrained land markets, lack of institutional financing, archaic and difficult regulations and an extremely painful construction process, to bring supply on line.

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<sup>1</sup> Dinesh Chandiok, interview, June 5, 1996.

Along with the huge price increases in the major cities, suburban developments are also on the rise and the smaller cities are beginning to see large scale developments come on line. These smaller cities offer the same level of returns with a much lower entry costs due to the lower land costs. Among the metros the Delhi market is still going very strong, Bombay and Bangalore have stagnated in the central areas but are picking up in the suburbs, and there is an increased interest in Calcutta and Madras. Among the second tier cities Pune, Hyderabad, Ahemdabad, Chandigarh, Jaipur, Lucknow and Cochin show huge potential for growth.

Although there is an increased interest, the level of knowledge about the market, in the US real estate investment community is very low. This thesis intends to provide a comprehensive overview of the Indian real estate market for the US investor.

The structure of the thesis is as follows: **Chapter One** outlines the institutional frame work of the country and gives a macro economic overview of the economy as well as the real estate sector. **Chapter Two** discusses the legal and structural issues which have shaped the Indian Real Estate industry. **Chapter Three** outlines the avenues available to the foreign investor for investing in the Indian real estate market and discusses the legal and taxation issues for each avenue. It also provides a framework for establishing and running an Indian company. **Chapter Four** gives a macro economic analysis of different cities and the various property types with regards to trends in rental and capital values, projected future demand for space and investments. **Chapter Five** presents the summaries and conclusions of the thesis.

### ***Institutional Framework***

#### **Federal System**

India, a union of states, is a Sovereign, Socialist, Secular, Democratic, Republic, with a Parliamentary system of Government. The Republic is governed in terms of the Constitution, which was adopted by Constituent Assembly on 26 November, 1949 and came into force on 26 January, 1950.

The President is the constitutional head of Executive of the Union. Real executive power vests in Council of Ministers with the Prime Minister as head. Article 74(1) of the Constitution provides that there shall be a Council of Ministers headed by Prime Minister to aid and advise President

who shall, in exercise of his functions, act in accordance with such advice. The Council of Ministers is collectively responsible to the Lok Sabha, the House of the People.

In the states, the Governor is the head of Executive, but real executive power vests with the Chief Minister who heads the Council of Ministers. The Council of Ministers of a State is collectively responsible to the elected legislative assembly of the state. The Constitution governs the sharing of legislative power between Parliament and the State Legislatures, and provides for the vesting of residual powers with the Parliament. The power to amend the Constitution also vests with the Parliament.

### **The Union Government**

The Union Executive consists of the President, the Vice President and Council of Ministers with the Prime Minister as the head to aid and advise the President.

#### **President**

The President is elected by members of an electoral college consisting of elected members of both houses of Parliament and Legislative Assemblies of the states, with suitable weightage given to each vote. His term of office is five years.

#### **Council of Ministers**

The Council of Ministers comprises of cabinet ministers, minister of states (independent charge or otherwise) and deputy ministers. The Prime Minister communicates all decisions of the Council of Ministers relating to administration of affairs of the Union and proposals for legislation to the President. Generally, each department has an officer designated as Secretary to the Government of India to advise ministers on policy matters and general administration. The Cabinet Secretariat has an important coordinating role in decision making at the highest level and operates under the direction of the Prime Minister.

The Legislative of the Union, called Parliament, consists of the President, the Rajya Sabha and the Lok Sabha. All legislation requires the consent of both houses of parliament. However, in case of money bills, the will of the Lok Sabha prevails.

## **State Governments**

The system of government in the states closely resembles that of the Union. There are 25 states and seven Union territories in the country. Union Territories are administered by President through an administrator appointed by him.

## **Political System**

A recognized political party has been classified as a National Party or a State Party. If a political party is recognized in four or more states, it is considered as a National Party. Congress, Bharatiya Janata Party, Janata Dal, Communist Party of India and Communist Party of India (Marxist) are the prominent National Parties in the Country. Telugu Desam in Andhra Pradesh, Asom Gana Parishad in Assam, Jharkhand Mukti Morcha in Bihar, Maharashtra Gomantak Party in Goa, National Conference in Jammu and Kashmir, Muslim League in Kerala, Shiv Sena in Maharashtra, Akali Dal in Punjab, All India Anna Dravida Munnetra Kazhagam and Dravida Munnetra Kazhagam in Tamil Nadu, Bahujan Samaj Party and Samajwadi Party in Uttar Pradesh and All India Forward Block in West Bengal are the prominent state parties.

Eleven Lok Sabhas have been constituted so far. Excepting the short-lived sixth and ninth and the latest eleventh Lok Sabha, the Congress Party has ruled the country. In general, Congress and Janata Dal are considered to be centrist parties while BJP is termed as rightist party and CPI and CPI(M) as leftist parties. Earlier, Congress had its support from scheduled castes and tribes, and muslims. But their supports to Congress seem to have diminished gradually. Even in the states, the regional parties or the non-Congress parties gained importance over the years.

The eleventh Lok Sabha has been constituted in July 1996. The government has been formed through a 13 party coalition of centrist and leftist parties with the Congress party supporting it from outside. The heartening fact to note here is that today all political parties irrespective of their agendas have accepted the idea of economic liberalization. The new Finance Minister Mr. P. Chidambaram stated in his first interview after assuming office, that the government wants to attract foreign investment worth US \$ 10 billion annually.<sup>2</sup> To signal its strong commitment to reforms the

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<sup>2</sup> Business India, June 17-30, 1996

government approved more than USD 2 billion of direct foreign investment in a week's time in July, 1996.<sup>3</sup>

The new Prime Minister (PM) H.D. Deve Gowda, in his earlier role as the Chief Minister (CM) of Karnataka was considered the most aggressive pro-reforms CM. In a recent poll of 50 CEO's by a business magazine 88 percent of the respondents were certain that the pace of the reforms will be maintained.<sup>4</sup>

## **Judicial System**

The Supreme Court is the apex court in the country. The High Court stands at the head of the state's judicial administration. Each state is divided into judicial districts presided over by a district and sessions judge, who is the highest judicial authority in a district. Below him, there are courts of civil jurisdiction, known in different states as munsifs, sub-judges, civil judges and the like. Similarly, criminal judiciary comprises of the chief judicial magistrate and judicial magistrates of first and second class.

Under the Constitution, Parliament has the power to make laws for the whole of or any part of the territory of India. The State Legislatures have the power to make laws for the States. The subjects on which legislation can be made are specified in the Seventh Schedule of the Constitution.

Parliament has the exclusive right to legislate in respect of items appearing in List I, called the "Union List". This list includes such items as defense, foreign affairs, currency, income tax, excise duty, railways, shipping, posts and telegraphs, etc.

State Legislatures have the exclusive power to make laws in relation to items appearing in List II called the "State List". This includes items like public order, police, public health, communications, agriculture, lotteries, taxes on entertainment and wealth, sales tax and octroi, etc.

Both Parliament and the State Legislatures have the power to legislate in items appearing in List III of the Constitution which is known as "Concurrent List". This list includes items like electricity,

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<sup>3</sup> Reuters news report, July 21, 1996.

<sup>4</sup> Business Today, June 7-21, 1996

newspapers, criminal law, marriage and divorce, stamp duties, trade unions, price controls, etc. All residuary legislative power are vested in the Parliament.

### ***Macro Economic Overview***

#### **Economic Reforms (1991-1995):**

After four decades of socialist and populist policies, which had brought the country on the verge of bankruptcy, the Indian National Congress government decided to go in for comprehensive economic reforms and free market policies in 1991. The reforms program was aimed at cutting the fiscal deficit, reducing growth in money supply, allowing greater play of market forces in resource allocation in both domestic as well as external sectors, and switching from borrowing to investment in external financing. The objective of economic reforms in India was stated<sup>5</sup> as bringing about rapid and sustained improvement in the quality of life of the people and fostering an economic environment which promotes rapid, broad based development. This was undertaken in India in the context of macro economic stabilization and structural adjustment, and in the light of various policy measures agreed with the World Bank and the International Monetary Fund (IMF). The reforms covered the area of fiscal imbalances, industrial policy and licensing system, foreign trade and payments regime, overhaul of the excise duty structure, financial sector changes, deregulation and privatization of various services.<sup>6</sup> A unified market determined exchange rate of the Rupee was introduced in March 1993 and the Indian Rupee is now convertible on the current account.

Rules and procedures for foreign investment in priority industries have been simplified by offering terms at par with other countries. Extensive reforms in direct and indirect taxes have been carried out in the light of the report of the Professor Raja Chelliah committee. Wide ranging reforms have been carried out in the banking sector in the light of the Report of the Narasimhan Committee on financial sector reforms.<sup>7</sup>

#### **Tax Measures and Reforms**

Over the past five years a number of structural changes covering both direct and indirect taxes were undertaken. They were geared to move towards a tax structure which is simple, relies on

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<sup>5</sup> Discussion paper of the Finance Ministry (1993) on Economic reforms.

<sup>6</sup> Economic reforms and the Stamp Act, National Institute of Public Finance and Policy, May 1995.

<sup>7</sup> *ibid.*

moderate tax rates with a wider tax base and better enforcement. The maximum marginal rate of personal income tax was reduced from 56 percent to 40 percent. The rates of corporate income tax (inclusive of a 15 percent surcharge) which were at a maximum of 57.5 percent were unified for all companies and reduced to 46 percent. The surcharge has been further reduced by the new Government to 7.5 percent, thus bringing the effective corporate tax rate to 43 percent. In the case of foreign companies (branches) the tax rate was brought down from 65 to 55 percent. The incentive structure for savings in the form of financial assets has been strengthened. The wealth tax which was earlier applicable to all personal assets, has been modified to exempt all productive assets including financial assets such as securities etc. The threshold limit for levy of wealth tax was raised to Rs. 1.5 million.

### **Foreign Exchange Markets**

In March 1993, India moved from a dual exchange rate regime to a single market determined exchange rate system. But the Reserve Bank of India (RBI) still intervenes to maintain market conditions and curb excessive speculation. Due to a large inflow of foreign portfolio investment in 1993 and 1994, the Rupee-Dollar rate remained steady at about Rs. 31.37 per dollar for about two years till July, 1995. But inflation being higher in India than most of its major trading partners, the real effective exchange rate (against a basket of 10 major countries) showed an appreciation of 8 percent.<sup>8</sup> This was compensated after August, 1995, when the Rupee depreciated to about Rs. 37 to a dollar as of February 9, 1996. Meanwhile the process of current account convertibility was carried forward with further relaxation in release of foreign exchange.

The Indian Rupee has been convertible on the trade account since August 1994. Capital inflows on one side and the Reserve Bank of India on the other kept it sandwiched at 31.37 INR to the US dollar between August 1992 and August 1995. Foreign exchange markets witnessed significant volatility in INR-USD rate after August 1995. In mid-October 1995, however, the rupee fell against the dollar and reached a low of Rs. 36 per dollar. It settled at around Rs. 34.6 per dollar by November end. During this period, the external sector remained under heavy pressure. Foreign exchange reserves with the RBI declined by around \$ 1.5 billion to \$17.5 billion, between the end of September and 17th November 1995. Repayment to the IMF, outgo on Foreign Currency Non

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<sup>8</sup> Economic Survey, 1995-96, Government of India



Resident Account (FCNRA) deposit scheme and central bank intervention in the forex market were the major reasons cited for the decline.

In January 1996, the Indian rupee on an average depreciated by 2.1percent. The average exchange rate was Rs. 35.7 per dollar. Thus, during April to January 1995-96, the Indian rupee depreciated against the US dollar by 11.5percent. During February 1996, the Indian rupee appreciated by 5percent against the dollar. On 29th February 1996, the average exchange rate of the rupee was 34.77 per dollar against 36.55 per dollar on 1st February 1996. The spot market is incredibly liquid, but this was largely a consequence of there being a last resort buyer (the Reserve Bank of India) and supply generally exceeding demand. However, on any given day, it is fairly easy to buy USD 100 million or so during the day.

There is an active forward market which is fairly liquid in the first month and quotes are easily available up to six months. Since July 1993, many one-year deals have also been taking place. The Reserve Bank permits banks to deal in the USD depo market within India, but access to the international market is very restricted. This, and the fact that there is really no properly developed term market in INR deposits, means that the connection between FX swaps and interest rates is tenuous at best. However, this is also steadily improving, and most dealers foresee a very active market up to one year soon.

Both the spot and forward markets exist only within India. The Reserve Bank prohibits any international speculative access to the Rupee. However, there is practically complete freedom to hedge any existing exposure arising out of commercial activity.

On 25 November 1995, the Finance Ministry relaxed the norms governing proceedings from issues of Global Depositary Receipts (GDR's). Companies were allowed to structure their borrowings as Foreign Currency Convertible Bonds (FCCB) with the average tenure for conversion of non-converted portion fixed at 5 years. The new Finance Ministry has decided to relax the minimum tenure of 7 years for external commercial borrowings (ECB's) completely.

Reacting to the depreciation of the rupee by 2 percent against the US dollar in the first week of February 1996, the RBI announced several policy measures to stimulate the supply of dollar and curb the demand for it.

## **Capital Markets**

The total market cap of the Indian stock markets was US \$ 138.6 billion and the number of listed companies at the end of 1995 was 7000. This makes it the second highest listing in the world after USA. With an investor base of over 20 million shareholders, it is the third largest market after US and Japan. The most important instruments in the capital markets are equity shares, fully convertible, partially convertible and non-convertible debentures.

Reforms have also been initiated in the capital markets, with the regulation of the market by the independent authority Securities and Exchange Board of India (SEBI). The National Stock Exchange (NSE) provides screen based trading and electronic clearing and settlement systems. The parliament has also passed a bill for the setting up of a central securities depository. The Foreign Institutional Investors (FII's) have been allowed to invest in the capital markets subject to SEBI guidelines and are benefiting from a liberalized tax regime. The Foreign Exchange Regulation Act (FERA) has been amended to remove a number of constraints for companies with foreign equity operating in India, NRI investment and repatriation of profits etc. The mutual funds industry has been thrown open to private and foreign players. SEBI is enforcing comprehensive regulations governing various aspects of the capital markets and intermediaries operating therein, with a view to improve trading practices, rules for disclosure and measures of investor protection. The companies are now able to raise capital without the need of any consent for issuing or pricing of securities, subject only to certain guidelines issued by SEBI.

The volume of issues in the capital markets are going up and new instruments are hitting the market, such as, Government issued zero-coupon five year bond, floating rate paper, short and medium term paper of the government, deep discount bonds, and certain issues of securitized debt. A vibrant debt market in instruments of different rates, maturities and yields is developing. A number of institutions and corporations have issued Euro Bonds and Global Depository Receipts (GDR's). Trading in debentures is still limited and overshadowed by equity trading, for want of market makers, and the risk perceptions. Some of the major housing and infrastructure finance companies are trying to issue mortgage backed securities, but have been restricted by legal constraints.

## Expansion of the Capital Market

### The Primary Market

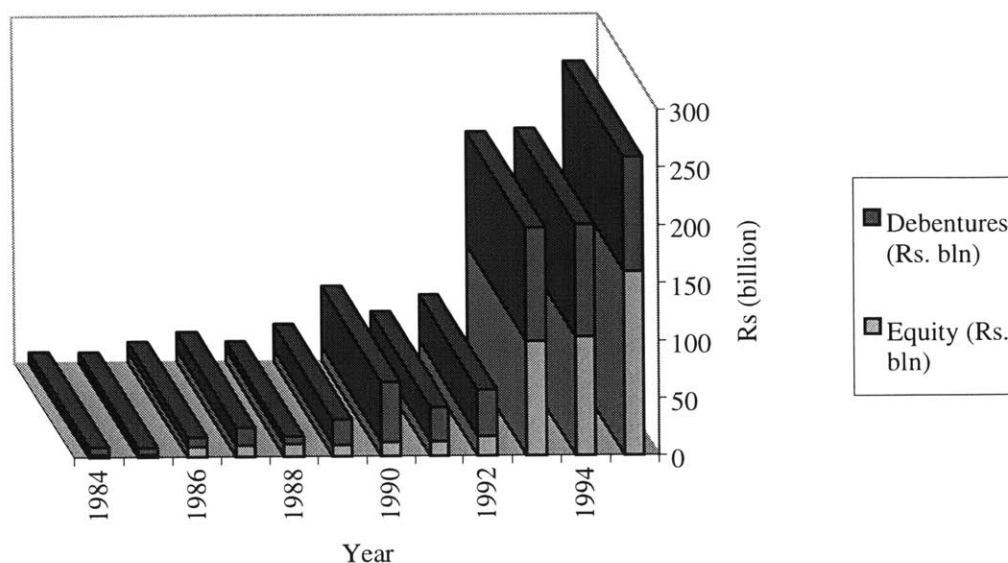
There is now a thriving market for Initial Public Offerings. The instruments commonly offered are equity, debentures, and a variety of convertibles including debentures bundled with warrants. Public issues are made by both private and public sector companies. Of the 130 issues per month taking place around now, roughly 70 are IPOs; this is one of the highest in the world. Unlike many other countries where issues are privately placed, public issues in India are directly marketed to retail investors all over the country.

Equity issues accounted for nearly 80 percent of the total capital issues during the sixties. The advent of public sector bonds and partly convertible debentures in the eighties played an important role in the changing mix of equity and debt instruments floated on primary capital markets. By the early nineties, equity issues amounted to only about 38 percent of the total resources raised. But this number changed again substantially to more than 65 percent by 1995.

*The time-series of resources raised from the primary market*

Year	Equity (Rs. bln)	Debentures (Rs. bln)	Total (Rs. bln)	Share in Net Savings
1984	2.5	6.6	9.1	4.60%
1985	2.5	6.1	8.6	4.30%
1986	9	8.4	17.4	7.50%
1987	10.1	15.6	25.7	9.40%
1988	11.1	6.7	17.8	4.80%
1989	10.4	21.9	32.3	6.90%
1990	12.3	52.8	65.1	10.10%
1991	13	30.1	43.1	5.90%
1992	17.6	40	57.6	6.90%
1993	99.8	98.4	198.2	21.70%
1994	103.4	97.5	200.9	NA
1995	159.85	99.28	259.14	NA

**Resources raised from the Primary Markets**



Source: India Economic and Business Overview, Center for Monitoring Indian Economy (CMIE), 1996.  
NA: Not Available

In recent years, Euro issues of GDRs and ECBs by Indian companies have taken place on a large scale. They have raised US \$ 5.18 billion through GDR's and foreign currency convertible bonds (FCCB's).<sup>9</sup> Use of GDR proceeds for investments in stock markets and real estate were expressly banned in June 1996.

In new guidelines announced on 26th May 1995, RBI has allowed for foreign investment in several service sectors, the implication for the capital market is that companies in the finance and leasing sector can issue shares and securities to Non-Resident Indians (NRI's) and Overseas Corporate Bodies (OCB's) on a repatriable basis. Hitherto, such an allotment was possible only with prior permission from the RBI.

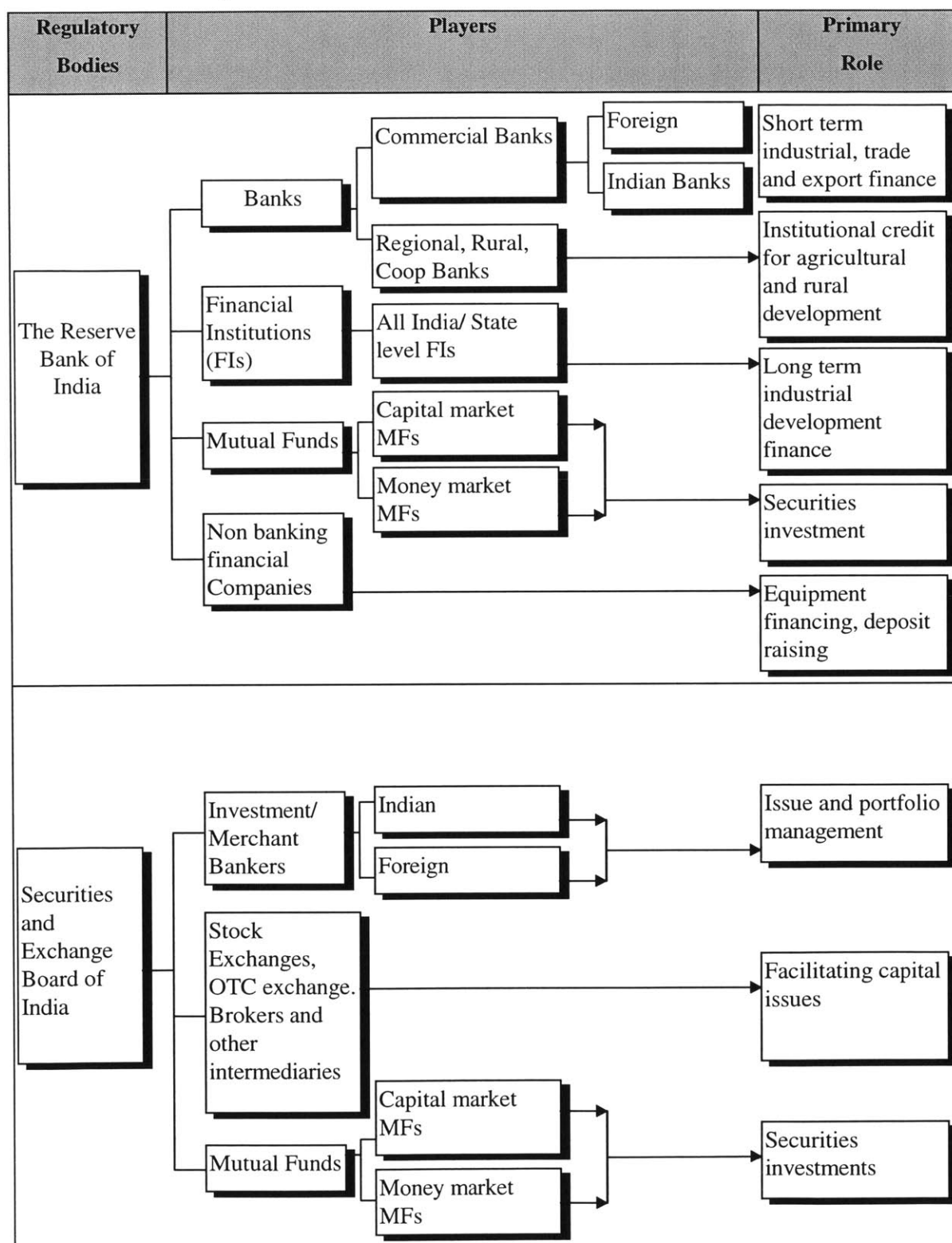
### **The Secondary Market**

Over the last five years, the secondary markets have also expanded considerably. The market capitalization of the Bombay Stock Exchange (BSE), one of the largest bourses in the country, has gone up from Rs. 54 billion in 1980 to Rs. 5,013.45 billion as on 31 May, 1996. The average daily

<sup>9</sup> Economic Survey, 1995-96, Government of India

turnover on the BSE was Rs. 4,360 million in May, 1996. Similarly, the trading volumes on the National Stock Exchange (NSE) touched Rs. 10.99 billion per day in May, 1996.

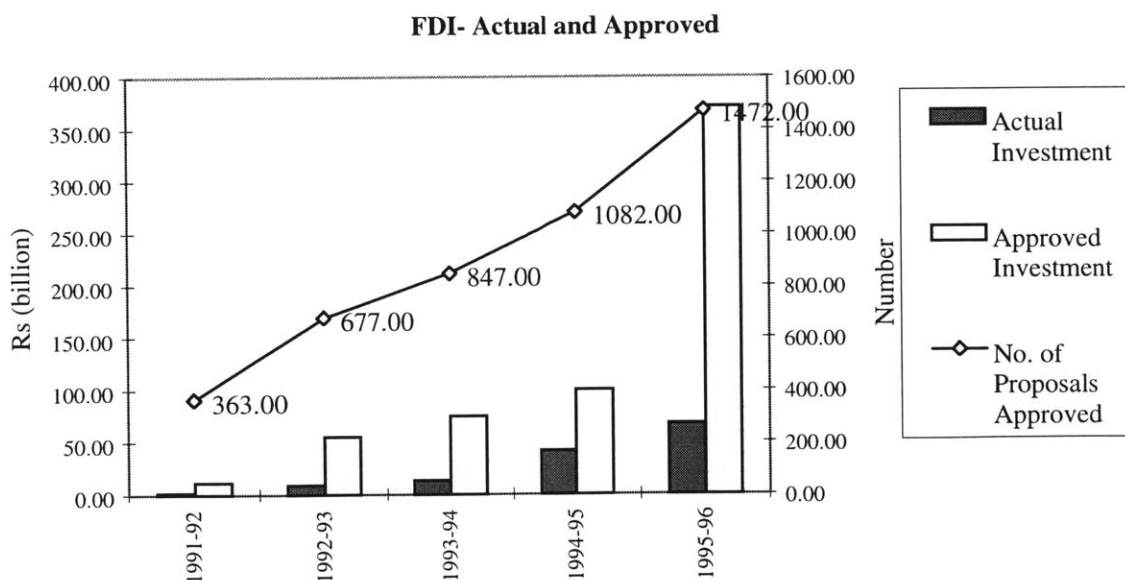
*The Indian Financial system: An overview*



## Foreign Direct and Portfolio Investment

The regulations governing foreign institutional investors (FIIs) earlier allowed investment only in listed securities. There was also a limit of not more than 5 percent for an individual FII and an aggregate of 24 percent for all FIIs in the stock of a listed company. Besides, FIIs were unable to invest in infrastructure because most infrastructure projects are set up by new companies which are not expected to be listed for some time. In the most recent budget in July 1996, the government raised the limit of 5 percent for an individual FII to 10 percent subject, however, to the aggregate limit of 24 percent for all FIIs, which still remains. They are also now allowed to invest in unlisted companies in the same manner as they are allowed to invest in listed companies. The revised guidelines are still to be issued separately by SEBI.

The response of foreign investment flows to the liberalization measures has been positive. Over the last three years foreign investment has grown at an average of 100 percent per year. The total inflow of foreign portfolio capital into the Indian capital Market, through GDR's, FII's etc. amounts to US \$ 8.9 billion,<sup>10</sup> since the launching of economic reforms. During 1995-96 the country received more than US \$ 2 billion in investments. This was 63 percent higher than the previous year.



Source: Center for Monitoring Indian Economy (CMIE), Monthly review, June 1996.

<sup>10</sup> Economic Survey, 1995-96, Government of India

The two major reasons why Indian markets are attractive to international portfolios are: high returns and low correlation with world markets. The long run rate of return of the BSE Sensex<sup>11</sup> has been 18 percent in real terms.<sup>12</sup>

Apart from Euro issues by Indian companies in the Euromarket, foreign investment companies have been operating in India, building up portfolios of Indian securities. Today, there are 365 Foreign Institutional Investors (FIIs) and 35 foreign brokers operating in India, and cumulative net investment by FIIs had reached nearly US \$4.79 billion by end of February 1996.

Total foreign investment of Rs 46.12 billion during the nine months ended December 1995, was 11.6 percent higher than the total investment inflow of Rs. 41.32 billion recorded during 1994-95. The total investment flow since 1991 till December 1995, at Rs. 121.5 billion was just 22.8 percent of the total foreign investment proposals worth Rs. 533.31 billion approved during the period.

### **Infrastructure**

An equally demanding challenge to India's economic development has been how to provide adequate and reliable infrastructure services at reasonable cost and with sustainable financing and pricing policies. It must be emphasized that unless there are major improvements in this area, the momentum of growth in industry, agriculture and exports can be lost. It is no exaggeration to say that the prospects for India's social and economic development depend crucially on the performance of infrastructure sectors, such as power, roads, railways, ports, irrigation and telecommunications.

Bringing about the necessary improvements will entail a paradigm shift from the old public monopoly approach to one in which private providers of infrastructure services are also actively encouraged. A significant start has been made in encouraging private providers in power, telecommunications, civil aviation, ports and roads. However much remains to be done to develop and implement viable policy frameworks and institutional structures. Independent regulatory authorities have to be established to set appropriate rates, harmonize design standards and

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<sup>11</sup> The BSE Sensex is a value-weighted index composed of 30 companies with the base April 1979 = 100. The set of companies in the index is essentially fixed. These companies account for around one-fifth of the market capitalization of the BSE.

<sup>12</sup> India- Economic and Business Overview, Center for Monitoring Indian Economy, 1996

specifications and generally promote the public interest. Transparent and workable rules and procedures for private investment and operation have to be clearly set out in each infrastructure sector. Since government owned entities will continue to be important providers of services in most infrastructure sectors, far-reaching reforms will have to be undertaken to increase the operational efficiency and accountability of these entities and ensure application of commercial principles in their operation and financial management, including tariff policies. In many cases, major institutional reforms will also be necessary.

Cost-effective expansion of infrastructure sectors will require massive amounts of long term finance. This, in turn, will require reforms of insurance and provident fund sectors and suitable policies for rapid and healthy development of markets for long term bonds. There is also enormous scope for attracting foreign direct investment in infrastructure sectors.

In order to encourage infrastructure funds established to mobilize resources for financing infrastructure facilities, they have been exempted from income-tax. Any dividend, interest or long-term capital gains of such funds or companies from investments in the form of shares or long-term finance in any enterprise set up to develop, maintain and operate an infrastructure facility will be free from income tax.

## **Employment**

Labor intensive growth was accorded the highest priority in the economic reform policies, hence additional employment increased from 3 Million in 1991-92 to 7.18 Million in 1994-95. Additional employment opportunities of the order of 18.78 Million are estimated to have been generated during this period. This implies an average rate of employment growth of 2.03 per cent. This trend is expected to continue in the future.

About 55 percent of the employment in the organized sector is in the services sector and less than 30 percent is in the manufacturing sector. The share of the public sector in the total employment in the organized sector increased from 68 percent in 1981 to 71 percent in 1991. Employment in the organized services sector increased from 156.9 million in 1990-91 to 162.3 million in 1993-94. The strength of females in the work force is 90 million. The Planning commission's estimates for the most recent year available (up to March 1995) indicates that the unemployment rate has increased from 4.29 percent in 1991 to 5.51 percent in March 1995.



*Increase in Employment (1989-95)*

Year	Total Employment (Million)	Annual % increase in total employment	Additional employment generated (Million)
1989-90	292.89	-	-
1990-91	298.73	1.99	5.84
1991-92	301.73	1.00	3.00
1992-93	308.31	2.18	6.58
1993-94	313.33	1.63	5.02
1994-95	320.51	2.29	7.18

Source: Planning Commission, Government of India.

*Sector wise Employment in the Organized Sector: 1976-1994 (percent)*

	Public Sector				Private Sector			
	1976	1986	1991	1994	1976	1986	1991	1994
Agriculture & Allied	2.69	2.97	2.92	2.8	12.08	11.15	11.61	11.14
Mining & Quarrying	5.4	5.46	5.24	5.22	1.93	1.51	1.30	1.28
Industry	19.82	21.38	20.50	20.00	62.63	61.81	59.84	59.52
Manufacturing	8.35	10.26	9.72	9.17	60.75	60.33	58.37	58.38
Power, Gas, Water Supply	4.02	4.44	4.75	4.83	0.51	0.54	0.52	0.51
Construction	7.45	6.68	6.03	6.00	1.37	0.94	0.95	0.64
Services	72.08	70.19	71.35	71.98	23.36	25.55	27.25	28.06
Trade & Commerce	0.42	0.74	0.79	0.83	4.19	3.76	3.91	3.80
Transpt, Storage & Commn	18.15	16.56	15.88	15.86	1.08	0.73	0.69	0.71
Finance & Real Estate	3.68	5.82	6.27	6.55	2.67	3.00	3.31	3.56
Public Administration	49.83	47.06	48.42	48.74	15.41	18.07	19.34	19.99
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: National Sample Survey Organization, Ministry of Labor, Government of India.

## Households and Income Levels

The annual per capita GNP for 1991 (as estimated by the World Bank) was USD 330, which translates into USD 1,851 per household (average size 5.61 members). This however does not adequately reflect the purchasing power of Indian incomes. International comparisons would be

more accurate in terms of the purchasing power of the currencies. The World Bank estimates this to be USD 1,150 per capita or USD 6,452 per household.

The latest household consumption survey<sup>13</sup> by the National Council for Applied Economic Research (NCAER) suggests that the number of households in the two highest income categories continue to show the maximum growth. As a result, the number of households in the high income levels is about 3.6 million, which is around 20 million people.

*Growth in Households (1989-93)*

<b>Growth in number of Households (%)</b>		<b>(1989-90 to 1992-93)</b>	
<b>Income Class (Rs.)</b>	<b>Urban</b>	<b>Rural</b>	<b>Total</b>
Low ( Up to 18,000)	8.7	6.1	7.8
Lower Middle (18,001-36,000)	-0.4	4.7	2.9
Middle ( 36,001-56,000)	-5.7	28.7	11.6
Upper Middle (56,001-78,000)	23.9	118.8	53.8
High (Above 78,000)	37.2	181.3	75.9
<b>Total</b>	<b>5.0</b>	<b>10.6</b>	<b>9.0</b>

Source: NCAER

*Household Income Distribution (1993)*

<b>Household</b>		<b>Income</b>	<b>Distribution</b>	<b>1993</b>	
		(Average	Annual	Income	in USD)
<b>Cities</b>	<b>Quintile I</b>	<b>Quintile II</b>	<b>Quintile III</b>	<b>Quintile IV</b>	<b>Quintile V</b>
Bombay	373.84	619.97	938.53	1552.92	2496.55
Delhi	290.00	679.30	1082.00	1495.90	3291.90
Madras	346.52	530.88	771.78	1492.23	2780.80
Bangalore	385.29	669.51	1143.91	1436.67	2486.77

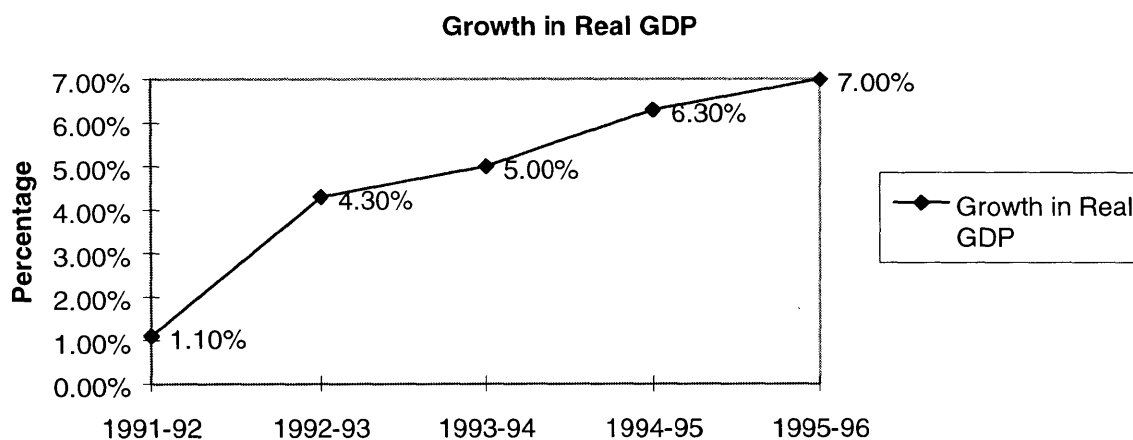
Source: Society for Development Studies, UNCHS City Indicators Program, based on city data from surveys conducted by BMRDA, NSSO, TRF, BMRTL, RITES. Note: 1 USD = INR 35, average in June, 1996

The NCAER surveys put the number of households in the middle and upper class at about 68.6 million, which translates into a population of 384.84 million. An interesting aspect of the urban economy is the disparity in household incomes.

<sup>13</sup> The survey covers about half a million people.

## Recent Economic Performance

The Economic Survey 1995-96 noted that India recorded one of the fastest recoveries from a macro economic and balance of payments crisis. It also stated that the growth achieved in the post-crisis period was a noteworthy achievement by international standards and was more sustainable than the growth in the immediate pre-crisis period. Data which has become available since then shows an even more buoyant outcome. Overall economic growth of GDP at factor cost, after rising to 6.3 per cent in 1994-95, accelerated further to 7 per cent in 1995-96. More remarkably, this is the first time that a growth rate of this magnitude was not due to exceptional agricultural growth.



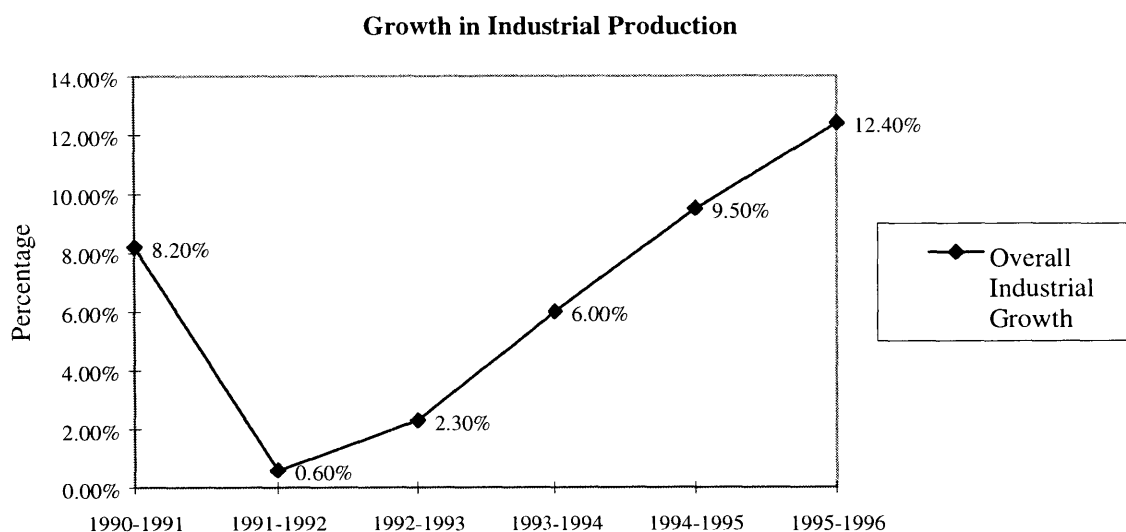
Source: Center for Monitoring Indian Economy (CMIE), Monthly review, June 1996 and the Economic Survey of the Government, July, 1996.

Since 1970-71, there have been only five years in which the growth rate reached or exceeded 7 per cent. Every one of these years was associated with a growth rate of 10 per cent or higher in the agriculture, forestry and fishing sector. In 1995-96, not only was the growth of this sector low, at 2.4 per cent, it was lower than the average growth of the agriculture and allied sectors over the nineties. The high growth was therefore due mainly to the 12.4 per cent growth of industry and construction sector and the 7 per cent growth of the services sector. Overall economic growth during the first four years of the Eighth Plan averaged 5.9 per cent per annum, a rate significantly higher than the Plan target of 5.6 per cent.<sup>14</sup>

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<sup>14</sup> Economic Survey, Government of India, July 1996

Industrial production has grown from a meager 0.6 percent to 12.4 percent for the same period.<sup>15</sup>



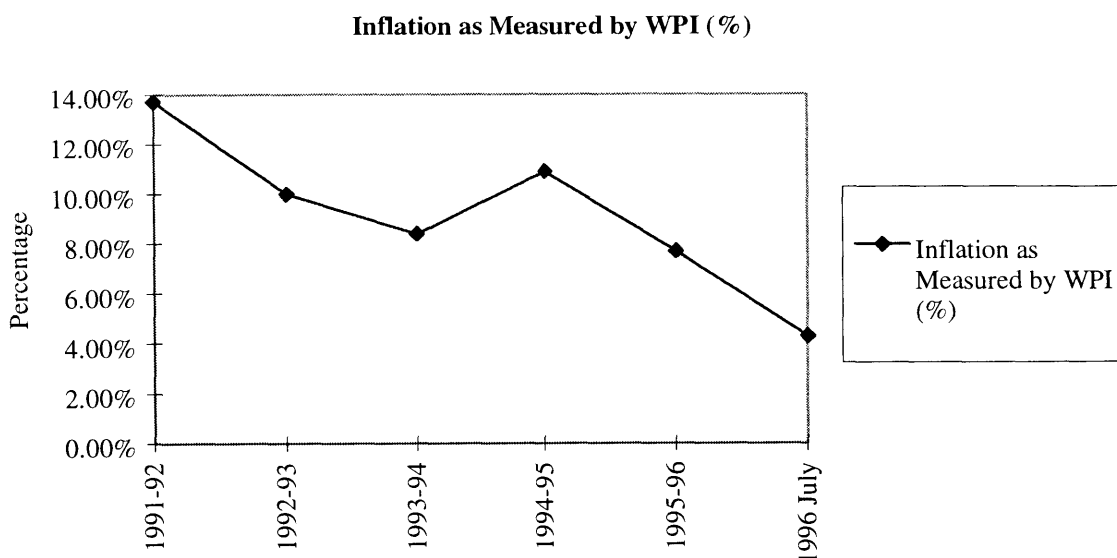
Source: Center for Monitoring Indian Economy (CMIE), Monthly review, June 1996 and the Economic Survey of the Government, July 1996.

The annual rate of inflation (based on the WPI) declined from 10.4 per cent at the end of 1994-95 to a low of 4.4 per cent at the end of 1995-96. The annual rate of inflation has remained low at 4.2 per cent until June 22, 1996.

The success in reducing inflation from an annual rate of 12 per cent in January 1995 to below 5 per cent in January 1996 is attributable to a combination of factors including the deceleration in monetary growth, high levels of open market sales of foodgrains, a liberal import policy, especially for essential commodities, and the surge in domestic supply associated with the acceleration of economic growth to 7 per cent. The delay in adjustment of administered prices also played a role.

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<sup>15</sup> *ibid.*



Source: Center for Monitoring Indian Economy (CMIE), Monthly review, June 1996.

Over the past five budgets the fiscal deficit has declined as a proportion of GDP from 8.3 per cent in 1990-91 to a revised 5.9 per cent in 1995-96. Much of this decline occurred, however, in the first year. Since then the fiscal deficit has hovered around six per cent of GDP, except for 1993-94 when the fiscal deficit was 7.5 per cent. This borrowing represents the Central Governments draft on the savings available to the economy for productive investment. The 2.4 per cent reduction in the fiscal deficit has been brought about by a sharper 3.2 per cent reduction in the primary deficit (equal to fiscal deficit minus interest payments). The primary deficit represents the effort made by the Government to control the deficit, as interest payments are largely predetermined by past borrowing. Unfortunately, this reduction in the primary deficit has been partly offset by a 0.8 percentage point increase in interest payments as a proportion of GDP. This, in turn, is largely a legacy of preceding primary deficits accumulated as debt.

The revenue deficit, on the other hand, has fallen only by 0.4 per cent of GDP over these five budgets, from 3.5 per cent of GDP to 3.1 per cent of GDP and remains too high for comfort.<sup>16</sup> The growth recovery has been accompanied by lower current account deficits and a rise in the gross domestic savings rate to a record level of 24.4 percent of GDP. Real gross capital formation was at 22.2 percent of GDP in 1994-95.

The Purchasing Power Parity estimates of GNP, based upon the Penn World Tables (PWT)<sup>17</sup> now put India in the fifth position in the world.

*PPP estimates of GNP based on Penn World Tables*

	GNP-1993 (USD bln.)	Rank	Per Capita GNP
USA	6,383	1	24,740
China	2,745	2	2,330
Japan	2,585	3	20,850
Germany	1,365	4	16,850
INDIA	1,096	5	1,220
France	1,083	6	19,000
Italy	1,016	7	17,830
UK	998	8	17,210
Brazil	837	9	5,370
Russia	752	10	5,050

Source: India Economic and Business Overview, Center for Monitoring Indian Economy (CMIE), 1996.

There are also some indications that the slow pace of economic reform in key government-dominated infrastructure sectors, such as electric power, and unresolved problems and constraints in the agricultural sector could undermine the recent pattern of accelerating aggregate economic growth. Since the latter part of 1995-96 and including the first two months of 1996-97, the rate of growth of electricity production has been slowing. The rail and road transport system and port capacities are also under strain. These are areas where economic reforms have been slow to take-off. Similarly, the growth of agriculture and allied sectors which was on the low side at 2.4 percent in 1995-96, is projected again at 2.3 per cent by Central Survey Organization for 1996-97 even assuming a normal monsoon. Sustained acceleration in overall GDP growth requires an acceleration in agricultural growth to around 4 percent per year.

<sup>16</sup> *ibid.*

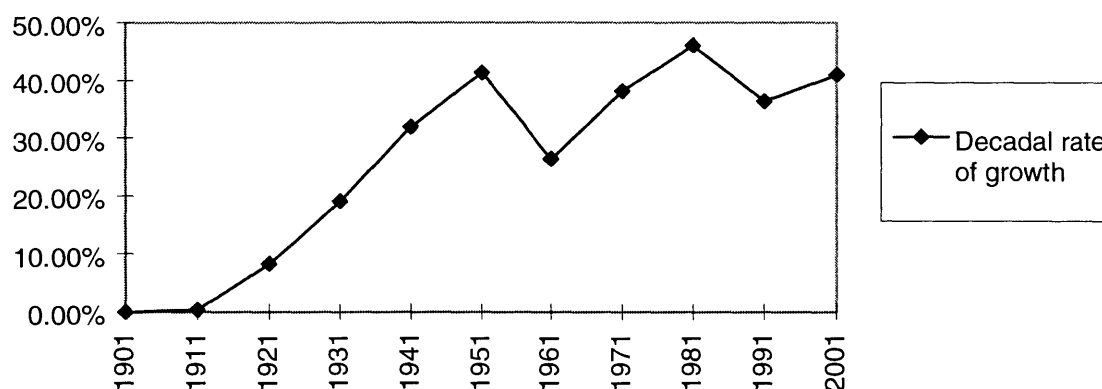
<sup>17</sup> The PWT are an ambitious attempt to arrive at macro economic aggregates for long time series which are comparable across countries. The PWT estimates are better at showing differences in income after compensating for differences in purchasing power between countries.

In a nutshell, sustaining the high growth trajectory attained in the last two years will require compression of the fiscal deficit, quick reforms in critical infrastructure areas, reinvigoration of agricultural growth and continued strength in the external sector.

### ***The Real Estate Sector***

Urban India houses 25.7 percent of the national population, aggregating 217.6 million in 1991 and is expected to be 250 million in 1996, making it one of the largest urban systems in the world. India has four mega cities (population 5 million plus), 19 metro cities (1 million plus), 300 large towns (0.1 million plus), and 3,396 small and medium towns (less than 0.1 million). By the turn of the century India will have some 40 metro cities. With economic growth rates averaging 6 percent, Industrial growth rates at 12 percent and inflation hovering at 9-10 percent, the environment is totally conducive for long term growth in the real estate sector. The real estate markets in the country have been booming for the past 5-6 years, with capital values increasing by 50-60 percent per year in some of the markets. The Indian market has been reacting to a huge pent up demand, fueled by a burgeoning Industrial and Corporate sector and a growing middle class estimated at 300 million people. There is today, an estimated shortage of 23 million units in the housing sector alone.

### **Urbanisation Trends**



Source: Census of India, 1991 and Planning Commission estimates.

## **Lack of Reforms**

Amongst the plethora of reforms that had been introduced in almost every sector of the economy, there had been one conspicuous absence - *The Real Estate Industry*. Before 1993 there was no initiative from the government's side to attract foreign investment into this sector, the market is not even completely open to the domestic investor. Land remains the most critical constraint in the development of the real estate sector, particularly in the larger cities. The sector was and to a certain extent still is governed by archaic and draconian clauses in the Urban Land Ceiling Act (ULCA), the Rent Control Act (RCA), Transfer of Property Act and the Stamp Duty Act. This has led to a severe supply side shortage in the market, this in combination with an extremely large demand base has resulted in unrealistically high real estate prices in the country. The government has woken up to this reality and has been making efforts to attract more investment into this sector and at the same time bring about more transparency in the real estate industry. In the most recent economic survey, it is stated,

“...radical and long overdue changes in the ULCA, rent control acts and municipal rules and regulations for building could unleash a construction boom across the country with enormous expansion of jobs. Reform of the ULCA would also release vital resources for industrial restructuring, which is going to be increasingly necessary in a more open, competitive economy.”<sup>18</sup>

## **Improving Legal & Institutional Framework**

At the same time the government is trying to improve the legal aspects of the industry, a model rent control bill has been passed by both houses of the parliament and has received the President's assent but could not be notified due to the onset of the 1996 general elections. There is a consensus among the different political parties on amending the ULCA so as to move towards free land markets, reduce corruption, speculation and profiteering and do away with the monopolistic practices of a small section of developers. Both these laws are expected to be amended within the year. The government is trying to increase the flow of investment into the real estate sector, specifically housing. The National Housing Bank (NHB), the premier refinancing institution of the country is encouraging the housing finance companies to issue Mortgage Backed securities. The high burden of taxes on Real Estate, which traditionally had led to the generation of a lot of black money, is being reduced. The capital gains tax has been reduced to a flat 20 percent already.

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<sup>18</sup> Economic Survey, 1995-96, Government of India



Although there is no central source for disseminating price information, as the brokerage community is not very well organized, and reliable long term time series data of rents and capital values is not available, the general perception amongst most of the players in the industry is that there is tremendous potential in all sectors of the industry in the major metropolitan as well as the second tier cities. According to Mr. Amit Chaudhary, CEO, Godrej Properties & Investments Ltd,

“...there is no concept of market share, it is based on what you can develop. There is limitless opportunity in the country, today.”

### **Routes for Foreign Investors**

The foreign investor today has a number of different routes for investing in Indian real estate. For Hotels and Industrial Parks there is an automatic approval process, and clearances for development are granted within 30 days of application. The markets have also been opened up for the Non Resident Indians (NRI) and Overseas Corporate Bodies (OCB's)<sup>19</sup> for all kinds of real estate investments, along with repatriation benefits. This route is still a bit unclear in terms of its regulations. Finally, for all kinds of Real Estate Development projects the investors can go to the Foreign Investment Promotion Board (FIPB) for direct approvals in relation to that particular project. All these avenues have been discussed in detail in chapter 3.

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<sup>19</sup> OCB's include overseas companies, partnership firms, trusts, societies and other corporate bodies which are owned directly or indirectly, to the extent of at least 60% by individuals of Indian origin resident outside India, as also overseas trusts in which at least 60% of the beneficial interest is irrevocably held by such persons.

## **Chapter Two**

### ***Structure of the Real Estate markets***

#### **Urbanization Dynamics and Real Estate**

A fundamental relationship exists between urbanization and economic growth. The experiences over the last four decades in India and even longer elsewhere in the world have shown that cities expand effective market size and stimulate economic activities, and population agglomerations make per capita investment on basic services a viable proposition. Urban areas have facilitated the evolution of knowledge and have been the incubators of civilizations and engines of growth. Urbanization sets in motion a series of activities that ultimately broaden the employment base of the country and contribute a higher value added component per unit of investment as compared to investment in the rural environment. Urbanization in India, as in other developing countries, is to be looked at as a catalytic agent of economic growth. Urban India's contribution to GDP is expected to cross 60 percent by the year 2001.<sup>20</sup>

Along with a widening gap in the demand and supply equation of basic infrastructure services and the real estate stock of the major urban centers, the growth of new towns and cities has also not been substantial in India. The migration trails now lead from small and intermediate towns to large towns where the income generation opportunities are perceived to be better. The total housing shortage was estimated at 23 million units in 1991.<sup>21</sup>

To create a vibrant urban environment in a growing economy the basic infrastructure required in the cities is the real estate, whether it is the office buildings, the housing stock, extensive retail outlets, all categories of hotels or industrial parks. Currently the market forces are not allowed to function in a healthy and well functioning capital market for real estate. Real estate is not categorized as an industry, and the laws relating to land and mortgages are not well defined, hence there is a complete lack of institutional financing for real estate in the country. As a result tremendous supply side constraints exist, this coupled with a growing demand base has led to exorbitant rise in real estate prices in all the major cities of the country. The price rise has been so

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<sup>20</sup> Eighth Five Year Plan, p.345

huge it made Mr. Dinesh Chandiok, managing director of Richard Ellis India, comment, that no local developer in Delhi will touch a project unless he gets an 80 percent before tax return.

## **Land & The Urban Land (ceiling & regulation ) Act, 1976 (ULCA)**

### **Restricted Land Markets**

Land scarcity has been one of the biggest impediments to the development of the real estate stock and the urban infrastructure services in India. The ULCA, whose basic objective was to make land available to all income segments in the society in urban agglomerations, has in practice, led to tremendous distortions in the land markets, giving rise to monopolistic situations, rampant speculation, profiteering and proliferation of illegal settlements. The act limits the ownership of land for a single person or entity, in an urban area, to 500 square meters (zone I), 1000 square meters (zone II) and 1500 square meters (zone III). The land supply has been frozen through ownership by government departments, large corporate enterprises, public, religious and charitable trusts, academic institutions and members of former princely families. Many private landowners who might have released their vacant lands have been restricted from doing so as they are frozen, neither being allowed to develop or transfer to others for development, until the cases are settled and land is either taken over by the government or released back to them. According to Mr. Jairam Ramesh, senior advisor to the Finance Minister, the act has outlived its utility and needs to be scrapped.<sup>22</sup>

### **Rampant Corruption**

The government on its part does not seem to have the money to take over the land. On the other hand sections 20 & 21 of the Act have led to rampant corruption, all sorts of exemptions under various pretexts have been granted to developers, resulting in their monopolizing a severely restricted land market. It has been found that out of 43,863.50 hectares of exempted land in the country, only 3,445 hectares were for housing the economically weaker sections (EWS) and 40,419 hectares were exempted on other grounds. Of the 166,192 hectares of excess vacant land the government has been able to acquire only 14,589 hectares. There now seems to be a general consensus in the political, academic and the business circles in terms of amending the ULCA. The government of India in its Economic Survey, 1995-96 has agreed that radical changes are required

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<sup>21</sup> Habitat II: India National Report, GOI, Ministry of Urban Affairs & Employment, 1996

in the ULCA and reforms in this area could release vital resources necessary for industrial restructuring and unleash a construction boom across the country with enormous expansion of jobs.<sup>23</sup>

### **Speculation and Profiteering**

Due to the freeze in the land market on account of proceedings under the Land Acquisition Act as well as the ULCA, there has been a speculative pressure on the land and prices have risen astronomically. Access to land at an affordable rate has been denied to many and has led to the development of unauthorized colonies and slums. On the other hand, people who can make payment partly in black money in extra legal transactions seem to have taken control of a substantial chunk of marketable urban land. Unregulated development of agricultural land has also taken place. Essentially these features have led to a foreclosure of competition in the market as only a few people are controlling the marketable land. These developers in turn oblige the buyers to pay in black money, thus setting in motion a chain of extra legal transactions, tax avoidance and black money.

### **Reduced Monopolistic Practices and Corporate Developers**

The functioning of the Land markets disrupted by the legislative intervention and unimaginative master plans is being brought on competitive lines, resting on a free flow of information. While unconstrained legitimate transfer of land and buildings is to be revived, the credit facility from the formal market for various forms of real estate activity has been encouraged. The earlier monopolistic practices of the developers have been reduced due to increased competition from the new breed of corporate developers. These are companies whose core business has not been real estate, but they have gravitated towards real estate development either because they were huge land owners or they were flush with funds. These companies being publicly traded, wish to maintain a certain level of transparency in their operations. They also try to maintain and utilize the brand equity, they have generated through other products, in their developments. Thus, the sector is getting an increased level of transparency and there is a reduction in monopolies.

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<sup>22</sup> Interview, Jairam Ramesh, 25th June 1996.

<sup>23</sup> para 76, Chapter 1, Economic Survey, 1995-96, Government of India

### **Public-Private Partnerships**

As the government is the biggest owner of urban land and does not have the resources to develop the land, it is encouraging public-private partnership for development projects. There have been a few projects in the country which have used this kind of a format, e.g. West Bengal Housing Board and Gujarat Ambuja have partnered to develop a township near Calcutta, similarly the Karnataka government has joint ventured with TATA's and a consortium of Singapore investors to develop the Software Technology Park (STP) in Bangalore and the state of Haryana has collaborated with a Japanese consortium (of Mitsui, Marubeni, Mitsubishi and the government of Japan) to develop an Industrial Model Township (IMT) close to Delhi. Such projects are being given more encouragement, as the government is trying to liquefy a frozen asset class and serve a social purpose at the same time.

Another major program that is being implemented in the country is "Guided Land Development," where public housing and development agencies take up the activities in partnership with private developers and builders. In urban areas, a land consolidation and land pooling mechanism is also being adopted with the support of the private land owners. As regards housing development, a network of public housing agencies and cooperative societies have been developed and the private sector builders are being provided support to take up development work.

### **Rent Control Act**

The rent control legislation's whose basic objective was to protect the tenant against exorbitant rent and arbitrary increases and to provide security of tenure, have severely constrained the real estate markets in a completely changed environment. It has led to a freezing of rents, low returns on investments for owners who want to lease, black market practices such as 'pugree' (key money), insurmountable difficulties in eviction of tenants and development of quasi legal instruments such as Power of Attorney and Leave and License agreements. The act has also been instrumental in reducing the accessibility of low income groups to rental housing as they cannot afford to pay large deposits. Due to these archaic rent control laws which are decidedly pro tenant, a vibrant rental and leasing markets had failed to develop. Wherever they existed it was for very short term leases and a lot depends on the credit rating of the tenants. Hence one heard of

thousands of units lying vacant in the metros.<sup>24</sup> Lack of a leasing market is probably another reason why institutional investors are shy of real estate in India, as they have to depend completely on capital appreciation and the income component is completely missing from the investments.

Due to the restrictions imposed by the rent control laws the markets have adapted by developing its own financing and rental structures to alleviate risks for the property owners. Restrictive rental laws and high municipal taxes cause landlords to seek as much money as possible as advance, in the form of undeclared security deposits, while keeping face rents low so as to minimize taxes. These security deposits can range from 50 to 70 percent of capital values in Bombay, 12 to 24 months rent in Delhi and 15-20 months rent in Bangalore. The exact amount of up front payments totally depend on the negotiating power of each party. Multinational Companies (MNC's) and domestic corporate clients are considered high credit tenants, hence they can pay lower deposits than other parties. They often offer letter's of credit to protect the landlord's rights at the end of the lease term.

The Model Rent Control legislation seeks to remove these anomalies and has been tabled in the parliament and recommended to the states. The Delhi Rent Control Bill, 1995, based on this model, was passed by both the houses of the Parliament and has received the President's assent but was not notified by the previous government due to the onset of the elections. It is expected to be passed in the next session of the Parliament. It seeks to provide the following :

- creation of tenancy compulsorily by written agreement;
- compulsory registration of all written agreements on tenancies, except in certain circumstances;
- limit the inheritability of tenancies;
- redefine the concept of rent payable and provide for its determination, enhancement and revision;
- ensure adequate maintenance and repairs of tenanted premises and facilitate further improvements, additions and alterations;
- balance the interests of the land lord and the tenant in the matter of eviction in specified circumstances;

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<sup>24</sup> Dalal Street Journal, Dec. 25 1995-Jan. 7 1996.

- provide for limited period tenancy and automatic eviction of tenants upon expiry of such tenancy;
- provide for the fixing and revision of fair rate and recovery of possession in respect of hotels and lodging houses;
- provide for a simpler and speedier system of disposal of rent cases through Rent Authorities and Rent Tribunal and by the jurisdiction of all courts barring the Supreme court; and
- enhance the penalties for infringement of the provisions of the legislation by landlords and the tenants.

If the Act is implemented in Delhi and is taken up by other states too, it will result in a more balanced rental market and increase the flow of investment into the real estate sector. At the same time it will also result in attracting the institutional investors and those with long term liability structures.

### **Urban Real Estate Finance & Real Estate Capital Markets**

This is probably one of the most important areas which has not been given due importance in the reforms process. A key factor in the development of the real estate stock of any country is the availability of long term financing at a relatively low cost of capital. The vast majority of Indians still depend on their own savings and other resources for their housing needs. The commercial developments are financed through advance payments by the buyers. Typically a developer uses internal funds only for the acquisition of land and then goes out and pre-sells the units. The construction of the project is financed through these pre-sales, hence the developer has recovered his investment even before the construction is complete. This leaves little incentive for the developer to have an active interest in the project. There is no long term lending available for the real estate sector. Limited amount of construction lending is available from the institutional sector (HDFC etc.) at about 22 percent per annum, where as the prime lending rate is at about 17 percent ( in June 1996).

Although a wide range of resource mobilization and credit instruments have been introduced by specialized entities like Housing Development Finance Corporation (HDFC) and Housing and Urban Development Corporation (HUDCO), their penetration levels in terms of the overall markets are very low. The absence of legislation on speedy mortgage foreclosure has been a major

constraint in the expansion and down-marketing of institutional finance for real estate. At the same time lack of provision of mortgage insurance has affected the penetration levels and the ability to raise funds for the real estate finance companies.

The premier housing refinance institution the National Housing Bank (NHB), which is also a regulatory body to promote, stimulate and develop the housing finance system, has done some effective work in this area. NHB has introduced and promoted the marketing of clientele specific instruments to service their needs. The NHB interventions in the development of specialized housing finance companies has led to increase in their deposit base to Rs. 20 billion. The total financial assistance of NHB has gone up to Rs. 25 billion over a period of 7 years and the total resource mobilization has gone up to Rs. 4 billion from about 0.5 million depositors. The government has also raised the ceiling on the deductibility of mortgage interest to Rs. 15,000<sup>25</sup> to provide relief to home owners. Even with all these developments there is a lot more which needs to be done.

Recently there have been moves towards developing the public markets for real estate. Some of the premier real estate lenders like the Housing Finance Development Corporation (HDFC) have sought to securitize some of their loan portfolios. Historically, they had not been able to do so because of very high level of stamp duties<sup>26</sup> and the difficulty in enforcing mortgages. But recently due to reduction in stamp duties in the state of Maharashtra, to 0.1 percent for the first sale and 0.001 percent for subsequent sales, there have been moves towards securitization. The NHB is also trying to encourage the development of a secondary market for mortgages. Some of the developers like DLF and Alacrity have also securitized the receivables from their projects with lenders like Citibank.

At the same time the Securities and Exchange Board of India (SEBI) has recently encouraged, in its Mutual Fund 2000 report, the setting up of Real Estate mutual funds. This is still at a draft

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<sup>25</sup> Finance Minister's speech to the parliament, 22 July, 1996.

<sup>26</sup> Stamp Duty is a one time levy payable, at the time of transfer of property, to the State government under whose jurisdiction the property lies. It varies from 3 percent to 11 percent from state to state. The governments consider the sale of securitized certificates as transfer of property.



stage, as the regulations are being drawn up. These funds are expected to be operational by 1997. There are currently about 35 applications with SEBI for setting up of real estate mutual funds.<sup>27</sup>

### **Lack of Long term Institutional Players**

There is a complete lack of any long term institutional investors in the property markets, although it would make perfect sense to have insurance companies and pension funds investing in real estate as they have long term liability structures and real estate tends to be a long term income producing asset. In the developed world they tend to be the biggest players in the property markets, whereas in India, till recently these sectors were specifically barred from investing in real estate. Also due to the lack of a leasing market they shy away from investing in Real Estate. Now, with the government announcing its intentions of opening the insurance sector to private and foreign participants, there is hope that they will become major players in real estate.

### **High Tax Burden and Tax Evasion.**

The interim report of the Tax reforms committee under Dr. Raja Chelliah (1992) has referred in para 4-18 to 4-20 to the unintended high tax burden on rental income and real property owing to the fact that the taxes falling directly or indirectly on the same bases are formulated independently without coordination. It has been calculated that, on a rental home earning an annual rental income of Rs Six Hundred Thousand (Rs. 600, 000), the income tax, the wealth tax and the property tax liability alone would come to 63.43 percent, not counting non-recurring levies like stamp duties and capital gains tax. This had led to a strong incentive to avoid or evade taxes, through undervaluation and by paying the price partly in black money. Undervaluation works well as both the buyers and the sellers have an incentive in carrying it out. While the seller gains by paying lower capital gains tax and the subsequent wealth tax, the buyer saves in terms of less payment of stamp duty and registration fees.<sup>28</sup> As a result real estate today probably is the largest sector used for stacking of black money. This situation has been partly amended due to the flat capital gains tax of 20 percent, but there is a lot more that needs to be done.

Notwithstanding the efforts initiated under the regime of economic reforms, the burden of real estate taxes continues to be high. While the two one time imposts, stamp duty and capital gains

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<sup>27</sup> "Richard Ellis India is advising SEBI on drafting the regulations for the Mutual Fund Industry", interview with Dinesh Chandiok, 5th June 1996.

<sup>28</sup> Black Money in the Real Estate Sector, NIPFP, Jan. 1995.

taxes require a payment of 19-27 percent of the purchase price of a property, three recurring levies, income, wealth and property taxes, takes away 55-63 percent of the rental income accruing from renting a house fully for residential use. The direction of policy change for reducing the tax burden has so far been more concerned with the problems of individual taxes which may not be sufficient for reducing the incentive for underreporting the value of land and buildings in the document of transfer presented for registration.

### **Real Estate and The Stamp Act.**

Due to the unusually high Stamp duties on the transfer of property, there has been a proliferation in undervaluing of property. This has led to generation of huge amount of black money as the parties involved in the transactions want to avoid the heavy stamp duties.

The National Institute of Public Finance and Policy (NIPFP), in a study<sup>29</sup> has recommended the following:

- The Government of India, in consultation with the state governments, prescribe uniform rates of duties for all central and related state instruments.
- The state governments should be persuaded to reduce the rates of duties on conveyances of property, as defined comprehensively in Maharashtra, to a maximum rate of 10 percent and nominal rate of duties for low value conveyances.
- To provide a monetary ceiling on registration fees and to provide for uniformly low rates of stamp duties in all states on equitable mortgages in respect of financial institutions, along with a more comprehensive definition of conveyances and agreements of sale.
- To delink the process of registration and stamping.
- To provide for annually or biannually (or even monthly) notified and widely publicized values of land and buildings in different areas on the basis of scientific valuation, public consultation and values reported with the Income Tax department (IT).
- To ensure widespread dissemination of the rules and procedures, and rates of duties, to institute people friendly efficient systems of registration and payment of duty, and coordinated working of different departments such as IT, municipal corporations, registration departments etc.

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<sup>29</sup> Economic Reforms and The Stamp Act, NIPFP, May 1995

## **Valuation and Appraisal Systems**

The Chelliah committee (1991) rightly points out that valuation has been a major problem, with regards to real estate. The committee called for an examination of the rules regarding valuation of properties. The Wanchoo committee (1971) had earlier pointed out the absence of a proper valuation machinery in the IT as being responsible for helping tax dodgers, facilitating the utilization of black money in investments, and providing scope for reduction of liability for direct taxes, whether on income, capital gains, wealth or gifts. Correct valuation of assets can contribute to an effective administration of Income tax, other direct taxes and stamp duties and for capturing the incremental values in urban property and will also provide the buyers a relatively true benchmark for future transactions. Understatement of purchase consideration for the purpose of registration not only causes loss of revenue from stamp duties, but also results in the evasion of Income Tax and wealth tax in the hands of the purchaser, while the vendor escapes his liability for capital gains tax.

Although sophisticated systems of valuation do exist in the country and there is a very competent class of professional valuers, tremendous under reporting of values takes place due to the high incidence of taxes on the property. Thus the problem of under valuation is tied more to the legal and taxation issues than with actual expertise in valuation. This has resulted in one of the largest mechanisms for fraud in the country.

## **Inefficient Pricing Mechanisms**

The markets are completely inefficient in terms of the way the prices are set and the information that is available to the investor or the consumer. There is no centralized system in any city which records the transaction price of any deal, except the Income Tax Department (IT) who is to be notified in case the transaction price exceeds Rs Seven and a half million (Rs. 7,500,000). The IT does not release these prices, hence the speculators and brokers have a field day providing misinformation in the markets to fragment markets and generate speculative conditions and the consumer is left dependent on hearsay.

It would make perfect sense for the government to disseminate price information for a generalized area through one of its existing agencies like the IT or the NHB. A regular publication of area wise property values, availability of rental housing along with the rent price would serve to reduce the

price setting role of real estate agents. This could flow from the proposed legislation to register developers and property agents and to require the rating of developers. This would bring about an increased transparency in the market and at the same time provide investors and consumers with an authentic source of price information.

### **Black Money in the Real Estate Sector.**

The use of unaccounted money in the Real estate market in urban India has emerged as a major problem. The fungibility of undetected money between the capital markets and real estate has further fueled the scope for the greater use of black money and has also resulted in unrealistic rise in the property prices due to large scale speculation. This has also caused significant welfare losses due to widespread evasion of taxes on transfer of immovable property on one hand, and the denial of the vast majority of the population from access to affordable housing. This has been facilitated by the stifling legal and regulatory framework for real estate and various constraints to real estate development that have been well recognized in many official documents.

An assessment of the transfer of immovable properties in the five metropolitan cities indicate that the generation of black money could be in the range of 66 to 73 percent of the declared value of the immovable property transferred. The estimated black income in the five metropolitan centers during 1988-89 was indicated to be around Rs. 12.92-23.29 billion.<sup>30</sup> The speculative use of black money is in part a consequence of conditions of induced scarcity of urban land, and, in part due to the product differentiation practiced by monopolistic competitors in a situation of poor information base for the consumers.

The informal financial market serves as an entry point of black money as the developers do not have access to formal finance due to the uncertain collateral status of their land. Thus, there is a case for enlarging of credit supply from the organized finance market in line with the statements in the National Housing Policy (NHP).

The government, in a move to curb the use of black money in real estate, has introduced a legislation giving the Income Tax authorities the right of pre-emptive purchase. Under this law, if the IT feels that the owner has under reported the price of the property, it can go in and purchase

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<sup>30</sup> Black Money in the Real Estate Sector: A Study, NIPFP, January 1995, p.137

the property from the owner at 10 percent more than the reported price. This has reduced the incentive to under report the property prices for tax avoidance purposes. The IT then goes and auctions these properties in the open market. This has also resulted in the establishing of a good bench mark for the prices in that particular area.

### **Rating of Real Estate Developers' Projects**

One of the most welcome changes in the real estate industry has been, the rating of development projects, developed by the Credit Rating Information Services of India Limited (CRISIL).<sup>31</sup> Only projects with an approved plan and permits are considered for a rating. The ratings are assigned based on the information provided by the developer, or obtained by CRISIL from sources it considers reliable. It basically does two analyses, Project Risk Analysis and Developer Risk Analysis. It charges a fee of 0.1 percent of the project size.

According to Mr. Sudhakaran, Manager CRISIL, in the Project Risk Analysis, the quality of legal title in respect of the property to be conveyed, quality of construction and timeliness of delivery of the proposed/completed project are assessed. The analysis of quality takes into account the specifications agreed upon by the developer and the buyer. In the Developer Risk Analysis, the track record of the developer, existing financial position, financial flexibility and management evaluation are some of the factors considered in order to assess the standing of the developer. CRISIL does a title search and gets a legal opinion for the same, scrutinizes the sanctioned plans, copies of all agreements between the buyers and the seller, receipts of all municipal, government rates, duties and taxes paid to date in respect of the property. It also examines the exemption order under the ULCA from the competent authority if applicable.<sup>32</sup>

This system will probably go a long way in bringing more transparency in the market. It can indicate the relative security of investment in a project, help developers mobilize funds for their projects from the organized sector and also help in the marketing of the projects.

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<sup>31</sup> CRISIL is a premier rating agency promoted by two of the largest financial institutions in the country, the Industrial Credit and Investment Corporation of India (ICICI) and the Unit Trust of India (UTI). It is based on the model of US rating agencies like S&P, Moody and Fitch etc.

<sup>32</sup> Mr. Sudhakar, interview, 11th June 1996.

## **Lack of Design and Construction Technology**

This is an area where the markets critically need new technology. The traditional methods of construction which are being used are inappropriate for large scale developments and are extremely labor intensive. There is a need to bring in more mechanization into this sector to shorten project time spans and reduce costs. Improved construction technology would reduce the cost of production and improve the quality and durability of the physical assets. Mr. Aashish Velkar, Manager-Colliers Jardine India, observed, that the local architects are also not conscious of efficient space planning and the execution of the design and construction is a big problem.<sup>33</sup> The architectural profession has changed in terms of the quantum of work but has not changed in terms of efficiency and productivity. The people's awareness is changing fast as they are now more exposed to the western world in terms of quality, aesthetics and styles. Also due to the liberalized import policies, it is now possible to import a host of building materials. Hence, this is an area where the foreign players can play the biggest role. Improved project and construction management systems will result in better quality of project in lesser time and at a lower cost. Foreign technology can also be assimilated with the local low cost systems to produce effective solutions for the Indian environment.

## **Title Data Base, Title Insurance and Information Management Systems.**

### **Title Data Base and Information Management Systems**

In a changing operational scenario where the government is to play the role of a facilitator and not a provider, it has become imperative that the local governments keep a strong data base and information management system. There is a critical need for updating and computerizing the land records system in India. This would go a long way in ensuring title security for prospective investors and buyers and also reduce the load on the judicial system. It will also ease the availability of mortgage finance as the financiers will be more comfortable with a clear and transparent system of land titles.

The existing system of registration of deeds and documents, where a large number of documents are required to prove title, confers only presumptive title on land and is also time consuming and cost prohibitive.

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<sup>33</sup> Mr. Ashish Velkar, interview, 13th June 1996.

It has been suggested in the India- National report (p.102) for Habitat-II, the world conference on human settlements in Istanbul, that an automated cadastral survey and land titling system should be developed to enable the land market to function efficiently and to facilitate the extension of institutional financial intermediation. The government can involve public and private sector land developers, housing agencies, municipal authorities and financial institutions in this effort. Apart from this, an information system on land registration is essential for efficient land management. This should also cover an inventory of publicly held land and its present estimated value so as to give the government an idea of the tremendous revenue generating capacity of this asset class.

Some organizations have taken steps towards this, these include, the management information system being developed by the Town and Country Planning Organization (TCPO), housing statistics data base being developed by the National Buildings Organization (NBO) and the National Sample Survey Organization's (NSSO) data base on human settlements. Certain financial institutions are also trying to develop databases in terms of their loan portfolios and client base profiles.

### **Title Insurance**

Title insurance in real estate transactions is completely absent in the Indian market. This is another area which critically needs foreign expertise. Now that the new government has decided to open up the insurance sector there is a feeling in the industry that title insurance would also come in, as people see a huge potential in the market.

### **Sustainable Land Use Planning and Management**

In order to improve the land use planning capabilities at the city level, the central government has launched an urban mapping scheme which utilizes advanced technologies such as remote sensing and aerial photography to prepare physical and utility maps on appropriate scales. The approach to the master plan is being rationalized to take into account new types of land use emerging with the process of urbanization. Efforts are on to develop a Geographic Information System (GIS), too.

### **Research activities for the Real Estate Industry**

Another critical factor which is missing in the real estate sector in India is any kind of methodological research. Real estate finance and capital markets as a subject is not taught in any

institute in the country. Apart from some research done by the National Institute of Public Finance and Policy (NIPFP) there is nobody else doing any kind of research work in this area. This fact is acknowledged by a cross section of people in the academic, institutional and the private sector. The government is trying to play a role here by encouraging agencies like Housing and Urban Development Corporation (HUDCO) and NHB to invest more in research.



## Chapter Three

### *Avenues for Foreign Investment in Indian Real Estate*

The stated objectives of the new industrial policy, announced in 1991, is to invite and facilitate foreign investments and, accordingly, simplified mechanisms have been installed for providing expeditious approvals. This has opened a number of different routes for foreign investors to invest in Indian real estate and infrastructure projects.

#### **Automatic Approvals Process**

Under this route, 35 high priority sectors have been identified by the government, which are accorded immediate automatic approvals. In the latest budget the Finance Minister has announced the expansion of the list of industries under the automatic approvals process.<sup>34</sup> The new list is expected to be announced soon. Under this scheme the real estate investors can invest in 'hotels and tourism related industry,' accordingly foreign investment up to 51 percent foreign equity is permitted by the Reserve Bank of India (RBI) through the automatic approvals process.<sup>35</sup>

The term "hotels" includes hotels, restaurants, beach resorts, tourist complexes providing accommodation and/or catering and food facilities to tourists. "tourism related industry" include among others units providing facilities for cultural, adventure and wild life experience; leisure, entertainment, amusement, sports and health units for tourists; and convention/seminar centers.

Foreign technology agreements for the hotel industry are eligible for automatic approval by the RBI subject to the following criteria:

(i) Technical and consultancy services, including fees for architects, design and supervision up to 3 percent of the capital cost of the project is allowed to be paid in foreign currency.

(ii) Franchising and marketing/publicity support fee of up to 3 percent of net turnover (gross receipts less credit card charges, travel agents fees, sales tax, statutory payments etc.) is allowed.

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<sup>34</sup> FM's speech to the parliament, July 22, 1996.

<sup>35</sup> Manual of Policy and Procedures Governing Industrial Approvals, Secretariat for Industrial Approvals, Ministry of Industry, Government of India.

(ii) Franchising and marketing/publicity support fee of up to 3 percent of net turnover (gross receipts less credit card charges, travel agents fees, sales tax, statutory payments etc.) is allowed.

(iii) Management fees (including incentive fee) of up to 10 percent of gross operating profit is allowed.

Apart from these, all foreign investment and returns are fully repatriable in this industry sector. The RBI accords automatic approval to all proposals covered under the high priority sectors, where the foreign investment in the equity capital of the Indian company is up to 51 percent; the requirement that foreign equity cover the foreign exchange requirements for import of capital goods needed for the project has also been dropped in the latest budget.<sup>36</sup>

Applications for the automatic approvals are to be submitted to the RBI in form FC(RBI) and approvals are normally available within two weeks of filing the applications. Due to the simplified procedures for this sector there has been an increased inflow of investment into this sector. A representative list of foreign invested projects in the hotels sector is given in the Appendix.

### **Investment with Approval from the Foreign Investment Promotion Board (FIPB)**

All proposals for foreign investment, including the ones in real estate, which do not fulfill any or all of the parameters prescribed for automatic approvals, have to go through the FIPB. As of July 15th, 1996, the effective control of the FIPB has been shifted from the Prime Minister's office to the industry ministry. The board now comprises of the Industry Secretary (Chairman), the Finance Secretary, the Commerce Secretary and the Secretary of External Affairs. A foreign investment promotion council has also been set up for promotional work and for formulating policy guidelines from time to time.

Approvals from the FIPB are normally available within 4-6 weeks of filing the application. A number of large scale projects have been started using this channel of approvals. The government on its part views purely speculative real estate investment with a certain measure of

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<sup>36</sup> FM's speech to the parliament, July 22, 1996.

An important development of the new liberalized policies is the opening up of the roads and highways sector to foreign participation, without any restriction on equity. The approval for such projects has to be taken from the government. Investors are permitted to finance, construct, maintain and operate highway projects on a 'Build-Operate-Transfer' (BOT) basis. They are also allowed to set up highway related facilities like restaurants, motels, shopping malls, parking and gas stations along the route. The preliminary investigations and feasibility studies for such projects is also conducted by the government and the cost is recovered from the investor finally awarded the work. The government also helps in the acquisition of land at its own cost. Such projects, being part of infrastructure development, are also eligible for the five year tax holiday scheme.

### **Investment through the Overseas Corporate Body (OCB) Structure**

In a scheme announced in 1993, to encourage Non-Resident Indians' (NRI's)<sup>37</sup> and Overseas Corporate Bodies (OCB's)<sup>38</sup> predominantly owned by NRI's investment into real estate, the government opened up the sector to them.

Under this scheme existing or new companies (public or private) engaged in real estate activities, have been allowed to issue equity shares/convertible debentures, up to a 100 percent, to NRI's and OCB's with repatriation benefits. Real Estate activities would include:

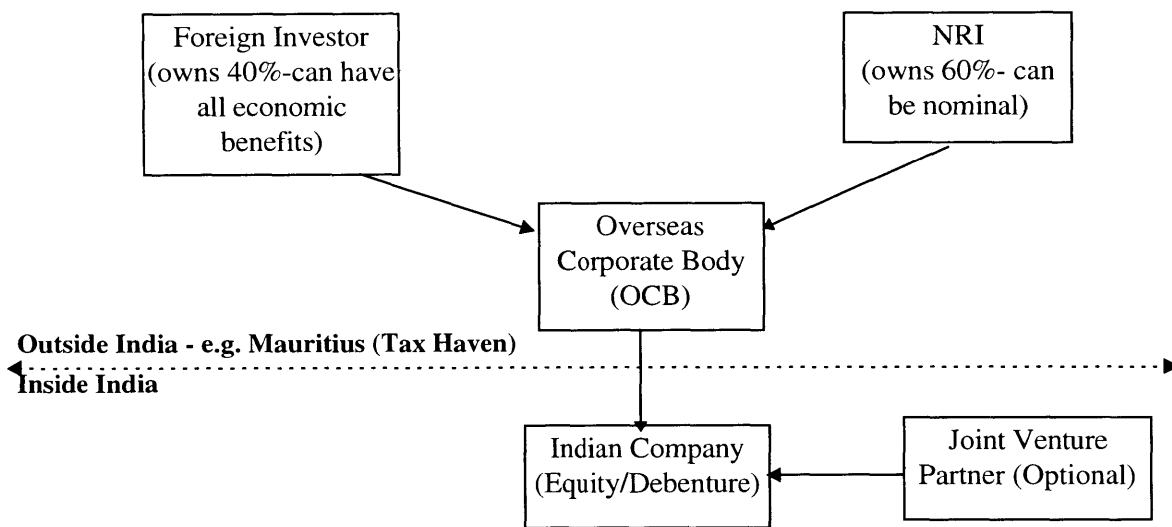
- Development of serviced plots and construction of built up residential premises.
- Development of residential and commercial premises, including business centers and offices.
- Development of townships.
- City and region level urban infrastructure facilities including roads and bridges.
- Financing of housing development
- Manufacturing of building materials

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<sup>37</sup> A person is deemed to be of Indian origin if he/she has held an Indian passport at any time, or his/her father or paternal grand father was a citizen of India by virtue of the constitution or the Citizenship Act, 1955.

<sup>38</sup> OCB's include overseas companies, partnership firms, trusts, societies and other corporate bodies which are owned directly or indirectly, to the extent of at least 60% by individuals of Indian origin resident outside India, as also overseas trusts in which at least 60% of the beneficial interest is irrevocably held by such persons.

Repatriation of original investment is allowed with the prior permission of the Reserve Bank of India only after a lock-in period of three years from the date of issue of shares/debentures. In addition, OCB's are also permitted to repatriate net profit (upto 16 percent) arising from the sale of such investment after the lock-in period of three years. However, dividend on equity shares and interest on debentures can be remitted, subject to payment of the withholding taxes, without any lock-in period. The following flow chart describes how the investment vehicle can be structured for foreign investor;



Using the above structure a number of different ways can be designed to assign the economic benefits to the foreign investor, making the NRI just a nominal investor. That would also depend on the jurisdiction where the OCB has been incorporated. The example of Mauritius has been given in the flow chart as it has the minimum withholding taxes in terms of repatriation. The corporate tax rates for different type of payouts is as follows:

*Tax Structure for foreign companies and OCB's*

	<b>Interest &amp; Dividends</b>	<b>Long Term Capital Gains<sup>39</sup></b>	<b>Business Income</b>	<b>Short Term Capital Gains<sup>40</sup></b>
Foreign Companies and OCB's	20 %	20 %	55 %	55 %

Further simplifications were announced by the Reserve Bank of India on 26 June, 1996, to encourage NRI/OCB investment.<sup>41</sup> Under the revised guidelines:

- Authorized dealers, mostly banks, are now allowed to sanction rupee loans to NRI's/OCB's against securities of shares. These shares could be held on a repatriation or non-repatriation basis.
- NRI's/OCB's are now permitted to raise rupee loans on a non-repatriation basis in India against collateral securities of their immovable property whether purchased by remittance from abroad or acquired otherwise.
- Safe custody of securities on behalf of NRI's and OCB's by institutional custodians besides authorized dealers.

Although NRI/OCB scheme opens up the real estate sector for the foreign investors to a large extent it is, in essence, a clumsily put together scheme. In the three years since this scheme has been introduced, the government has cleared about 352 applications for a proposed investment of about Rs. 10.57 billion, the actual inflows have only been to the tune of Rs. 1.51 billion.<sup>42</sup> This shows that the investors have not been excited by the scheme and there is general skepticism on their part. This can partially be traced back to the lack of clarity on the government's part, in terms of repatriation of profits. It is not even clear, that the limit of 16 percent for repatriation of profits is on the overall investment or one is allowed to take back only 16 percent of total profits. Since nobody till now has actually repatriated the earnings, the issue is still under scrutiny by the market.

### ***Establishing and Running an Indian Company***

Companies incorporated in India and branches of foreign corporations are regulated by the Companies Act.

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<sup>39</sup> Long Term holding is for a period of more than three year (one year for listed securities).

<sup>40</sup> Short Term holding is for a period of less than three year

<sup>41</sup> From the Economic Times, 26th June, 1996.

<sup>42</sup> Source: The Reserve Bank of India

### **Type of Company: Public or Private**

The main differences between the two categories relate to the provisions of the Companies Act that are not applicable to private companies. These include:

- Provisions as to the type of share capital, further issue of share capital, voting rights, issue of shares with disproportionate rights, etc.
- Provisions restricting the company from giving financial assistance to subscribe to its own shares.
- Provisions restricting the amount of managerial remuneration paid and certain other provisions relating to managerial personnel.
- Provisions restricting the powers of the Board of Directors and restricting loans to them.

Private companies are deemed to be converted into public companies in the following circumstances: When not less than 25 percent of the paid up capital of the company is held by one or more corporate bodies. When the company holds 25 percent of the paid up share capital of a public company. When the average annual turnover of the company exceeds Rs. 100 million. When the company accepts deposits from the public.

On becoming a deemed public company, many provisions of the Companies Act, 1956 in respect of which the company had exemption as a private company would become applicable.

<b>Private Companies</b>	<b>Public Ltd. Companies</b>
Restriction on transfer of shares.	Shares are normally freely transferable.
Number of members between 2 and 50.	Minimum 7 members required.
Prohibits invitation to the public for capital issues.	No restriction on inviting public for capital issues.
Taxation rates are higher.	Taxation rates are normally lower.
Many provisions of the Companies Act are not applicable.	Wide coverage of Companies Act.

## **Incorporation**

### **Approval of Name**

The first step in the formation of a company is the approval of the name by the Registrar of Companies (ROC) in the state/union territory in which the company will maintain its registered office. This approval is provided subject to certain conditions, for instance, there should not be an existing company by the same name. Further, the last words in the name are required to be “Private Ltd.” in the case of a private company and “Limited” in the case of a Public Company.

### **Memorandum and Articles**

For the purpose of incorporation, certain documents are required to be submitted to the Registrar Of Companies (ROC) along with the application for incorporation. The most important amongst these documents are the Articles and Memorandum of Association.

The Memorandum of Association is a document that sets out the constitution of the company. It contains, among other things, the objects and the scope of activity of the company and also defines the relationship of the company with the outside world. A company is required to act within the powers conferred on it by the objects specified in the Memorandum.

The Articles of Association contain the rules and regulations of the company for the management of its internal affairs. While the Memorandum specifies the objects and purposes for which the Company has been formed, the Articles lay down the rules and regulations for achieving those objects and purposes. This document is subordinate to the Memorandum of Association. The preparation of the Articles of Association is essential in the case of private companies, although it is optional for public companies. In case a public company does not register its Articles of Association, the Companies Act contains a model which would then apply to the company.

The ROC will give the certificate of incorporation after the required documents are presented along with the requisite registration fee, which is scaled according to the share capital of the company, as stated in its Memorandum. A private company can commence business on receipt of its certificate of incorporation.

A public company has the option of inviting the public for subscription to its share capital. Accordingly, the company has to issue a prospectus, which provides information about the company to potential investors. The Companies Act specifies the information to be contained in the prospectus.

The prospectus has to be filed with the ROC before it can be issued to the public. In case the company decides not to approach the public for the necessary capital and obtains it privately, it can file a “Statement in Lieu of Prospectus” with the ROC. This statement is required to contain information similar to that in a prospectus.

On fulfillment of these requirements, the ROC issues a Certificate of Commencement of Business to the public company. The company can commence business immediately after it receives this certificate.

### **Share Capital**

#### Types of Share Capital

A public company may have two different types of shares carrying varying rights with respect to dividends and voting, namely, equity shares and preference shares. Private companies may issue other types of shares as well. The nominal value is generally Rs. 10 per share for equity shares and Rs. 100 per share for preference shares.

#### Transfer of Shares

The shares of a company are regarded as movable property and can, hence, be transferred freely. However, the manner of transfer is specified in each company’s Articles of Association, which may impose restrictions on the right of transfer. Prior approval of RBI is required for share transfers to non-resident Indians and foreigners.

### **Debentures**

Within the framework of Securities and Exchange Board of India (SEBI) guidelines, debentures can be issued to raise funds for setting up new projects, expansion/diversification of existing projects, restructuring of capital, etc. The common types of debentures are fully convertible debentures (FCDs), non-convertible debentures (NCDs) and partly convertible debentures (PCDs).



## **Capital Issue Guidelines**

Following the abolition of the office of Controller of Capital Issues and the consequent removal of administrative control over the pricing of new issues, the capital markets now enjoys a considerable degree of freedom. New companies, being set up by existing companies; with a five year track record of profitability, are free to price issues, provided the participation of the promoters is not less than 25 percent of the equity of the new company and the pricing is made applicable to all new investors symmetrically.

Where a new company is set up by existing private sector companies along with a state level agency, or a government company, or a foreign collaborator, it will be sufficient if the private sector companies alone satisfy the requirements of five year track record of profitability.

Existing profitable companies issuing capital for augmenting their own capital base are free to price their issue. At the same time, the practice of making preferential allotment of shares, unrelated to the prevailing market prices was stopped by SEBI.

In any capital issue to the public, there is a specified minimum capital contribution to be made by the promoters. To reduce the cost of the issue, underwriting of issues has been made optional, subject to the condition that if an issue is not underwritten, and is not able to collect 90 percent of the amount offered to the public, the entire amount collected would be refunded to the investors.

Where fully convertible debentures (FCDs) are to be issued, the interest rate can be freely determined by the issuer. Companies are required to create a Debenture Redemption Reserve (DRR) equivalent to 50 percent of the amount of debenture issue before debenture redemption commences.

The cost of issuing capital, as of December 1992, was estimated at approximately 9-19 percent of the issue. This included fees for issue management, underwriting fees, stationary costs, advertisement and publicity costs, mailing costs, brokerage, etc. companies have a variety of options which entail lower issue costs, such as GDR issues, private placement, and bought-out deals.

SEBI's intention of passing on some part of its responsibility to the lead managers is reflected in the new guidelines announced in May 1995. The major decisions were:

SEBI has decided to stop vetting of rights issues all together. The onus of this responsibility will now rest with the lead managers. The procedure for clearance would be that the merchant banker would have to file the offer document with SEBI six weeks prior to the proposed date of offer of the rights issue. If SEBI does not ask for clarifications within 21 days from the date of filing, the company and the lead manager can proceed with the issue. SEBI also revised the guidelines for reservation in public issues. As per the new guidelines which have taken effect from 1 June 1995, half of the net public offer should be reserved for small applicants, i.e. those applying for less than 1,000 shares/securities. The other half would be reserved for the corporate applicants.

A committee comprising of senior executive directors of the five divisions of SEBI has been formed which will clear all public issues which are more than Rs. 1000 million. Formerly, all the issues were cleared by the primary markets division. Issues less than Rs. 200 million would be cleared by the division chiefs, those between Rs. 200 million and Rs. 500 million by the executive directors and those between Rs. 500 million and Rs. 1000 million by the senior executive director.

SEBI released guidelines on disclosure practice on offer documents largely based on the Malegam Committee Report. The major disclosure guidelines are:

Companies will have to show a turnover bifurcation of manufacturing and trading activities in their offer documents. Financial projections for projects which are not appraised have been disallowed. Projections will be provided only if projects are appraised by banks or financial institution. The offer document would have to contain a discussion on the financial results of the company by the company's management. The offer document would also have to contain the breakup of the ten largest shareholders of the company. These guidelines were made applicable for all offer documents filed with SEBI on or after 1 November 1995.

In February 1996, SEBI issued a clarification on its guidelines on preferential allotments made during a public issue. As per the revised guidelines, there will not be any lock-in period for all categories of investors, except the promoters. Issues of existing companies with an equity capital of

Rs. 500 million and dividend track record of 3 years in the previous 5 years will be cleared within 21 days of the filling of the offer documents. In making a preferential allotment to employees, the ceiling of 200 shares per employee has been removed but the overall cap of 10 percent of the issue size has been retained.

SEBI has also decided not to vet issues of pure debt of companies which are listed on some stock exchange and which have got an adequately safe rating for their debt instruments. This, however, does not apply to fully or partly convertible debentures and for non-convertible debentures with warrants attached since all these instruments have some portion of equity. These guidelines assume effect from 4 March, 1996.

### **Administration, Management and Payouts**

#### **Dividends**

Dividends may be paid out of the profits of a year, undistributed profits of previous years and money provided by the Central or any State government for the purpose, in pursuance of a guarantee given by the government concerned. Dividends received in India can be repatriated subject to taxation and exchange control formalities.

#### **Directors**

Under the Companies Act, it is necessary for a private company to have at least 2 directors and a public company to have at least 3 directors. Further, it is also necessary for every company to have a Board of Directors. The Act also contains provisions regarding appointment, removal, remuneration, powers, duties, etc. of directors.

The Articles of Association of every company contain provisions regarding remuneration to the directors. The Companies Act, however, prescribes an overall limit on total remuneration payable to all managerial personnel which is 11 percent of the net profits of the company during the financial year. If in any particular year there are none or inadequate profits, the company may, after obtaining approval, pay any sum by way of minimum remuneration. Provisions relating to managerial remuneration do not apply to an independent private company.

The directors have the power to perform all such acts as the company is authorized to perform. These powers however, must be exercised as a Board and not individually. The Companies Act

makes it obligatory for the Board of Directors to meet at least once in every three months and at least four times every year.

#### Accounting

Every company is required to maintain books of accounts showing all sums received and expended by the company, all sales and purchases of goods, all assets and liabilities and utilization of material and labor. The accounts must give a true and fair view of the state of affairs of the company. Account books are required to be preserved for eight years. The annual accounts, i.e. the balance sheet and the profit and loss account are required to be presented to the shareholders at each Annual General Meeting (AGM).

#### Audit Requirements

Audit of the books of accounts of companies is compulsory under the Companies Act and is known as a Statutory Audit. The Act contains provisions relating to appointment, removal, remuneration, powers, duties, etc. of a company auditor. Under the Companies Act, the Central government may order a special audit in case it is of the opinion that the affairs of the company are not being managed in accordance with sound business principles or that the financial position is likely to endanger its solvency. Audit of cost accounts may also be ordered by the Central government for certain types of industries.

### **Taxes- Corporate and Individual**

#### **Corporate Income Tax**

The taxation of a company's income depends on its domicile. Indian companies are taxable in India on their worldwide income. Foreign companies are taxable on income that arises out of their Indian operations, or, in certain cases, income that is deemed to arise in India. Royalty, interest, gains from sale of capital assets located in India (including gains from sale of shares in an Indian company), dividends from Indian companies and fees for technical services are all treated as income arising in India.

Income of companies is taxed at the following rates:

Type of Company	Tax Rate - 1996 (%)
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Domestic Company	40
Foreign Company	55

A surcharge of 7.5 percent<sup>43</sup> of the amount of tax payable is levied on domestic companies, if taxable income exceeds Rs. 75,000. The surcharge is not applicable to foreign companies.

#### Taxable income

The main source of income of a company is generally from “business.” A company would also earn income from under the following heads:

- rental house income
- income from capital gains
- income from other sources

Taxable income is calculated according to the rules for each class of income and then aggregated to determine total taxable income.

While calculating income from business or profession, expense incurred wholly and exclusively for business purposes are generally deductible. These include depreciation on fixed assets, interest paid on borrowings in the financial year etc.

Certain expenses are specifically disallowed or the amount of deduction is restricted. These expenses include: Entertainment expenses, interest or other amounts paid to a non-resident without deducting tax, corporate taxes paid, indirect general and administrative costs of a foreign head office and traveling within India.

#### Set-Off and carry forward of Losses

Business losses incurred in a tax year can be set off against any other income earned during that year, except capital gains. Unabsorbed business losses can be carried forward and set off against business profits of subsequent years for a period of eight years; the unabsorbed depreciation element in the loss which were earlier allowed to be carried forward indefinitely, is also now allowed to be carried forward only for a period of 8 years.<sup>44</sup> However, this carry forward benefit is not available to closely held (private) companies in which there has been no continuity of business

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<sup>43</sup> This surcharge used to be 15 % and was reduced in the July 1996 Budget report.

<sup>44</sup> Budget Report, July, 1996.

or shareholding pattern. Also, any change in beneficial interest in the shares of the company exceeding 51 per cent disqualifies the private company from the carry forward benefit.

### **Individual Income Tax**

Taxation of individuals is determined by their residential status. An individual is 'resident' if he/she stays in India in the fiscal year (April 1 to March 31) either for 182 days or more, or for 60 days or more (182 days or more for NRIs) and has been in India in aggregate for 365 days or more in the previous four years. An individual who does not satisfy either of these requirements is a 'non-resident'.

A resident individual is considered to be 'ordinarily resident' in any fiscal year, if he has been resident in India for nine out of the previous ten years and, in addition, has been in India for a total of 730 days or more in the previous seven years. Residents who do not satisfy these conditions are called individuals 'not ordinarily resident'. Remuneration for work done in India is taxable irrespective of the place of receipt. Remuneration includes salaries and wages, pension, fees, commissions, profits in lieu of or in addition to salary, advance salary and perquisites. Allowances, deferred compensation and tax equalization are also taxable. Perquisites are taxed beneficially. Taxability of individuals is summarized in the table below.

Status	Indian income	Foreign income
Resident and ordinarily resident	Taxable	Taxable
Resident but not ordinarily resident	Taxable	Not taxable
Non-Resident	Taxable	Not taxable

Besides remuneration for work, individuals may be taxed on the following income:

- rental house income
- income from business or professions
- income from capital gains
- income from other sources.

Spouses are treated separately for tax purposes and their income is not normally clubbed. The Finance Act, 1994 has increased the income tax exemption limit, and abolished surcharge on income tax for individuals.

*Individual tax rates*

<b>Taxable income slab (Rs.)</b>	<b>Rate (%)</b>
Up to 40,000	Nil
40,001 - 60,000	20
60,001 - 120,000	30
120,001 upwards	40

Special provisions relating to income of Non-Resident Indian Individuals:

When the income of an NRI consists only of investment income or income from long-term capital gains, the tax payable is at the rate of 20 per cent. Capital gains on transfer of assets acquired in foreign exchange is not taxable in certain cases.

Non-resident Indians are not required to file a tax return if their income consists of only interest and dividends, provided taxes due on such income are deducted at source. The tax rate on such income is 20 per cent. It is possible for non-resident Indians to avail of these special provisions even after becoming residents by following certain procedures laid down by the Income Tax act.

### **Capital Gains Tax**

Gains on sale of capital assets held for more than three years (one year for listed securities or mutual fund units) are treated as long-term capital gains and are taxed at concessional rates compared to short-term capital gains.

While calculating taxable long-term capital gains, the cost of acquisition and the cost of improvement are linked to a cost inflation index. As a result, the indexed cost of acquisition is deducted from the sale consideration received, to arrive at the capital gains.

Long-term capital gains are taxed at a flat rate of 20 per cent for individuals, foreign companies, and domestic companies.<sup>45</sup> Long-term capital gains on the transfer of shares/bonds issued in a foreign currency under a scheme notified by the Indian Government are taxed at 10 percent. For non-residents, the capital gains arising from the transfer of shares and debentures are calculated in the original currency of acquisition. Therefore, no tax is payable merely because of the devaluation of the Indian Rupee vis-à-vis other currencies. However, no tax is payable on the transfer of shares in an Indian company by one non-resident to another if the transfer is in pursuance of a scheme of amalgamation and certain conditions are satisfied.

The concessional treatment allowed to long-term capital gains is not applicable to short-term capital gains. Short term capital gains are computed as the sale price or consideration less cost of acquisition and related expenses. The taxable short term gain is aggregated with taxable income from other income classes, and is taxed at the overall tax rate applicable to the assessee.

Income of offshore funds and non-residents from units purchased in foreign currency and capital gains on their transfer are taxed at 10 percent. In the case of foreign institutional investors, income from investment in securities (viz. dividends, interest) is taxed at 20 percent, while capital gains on transfer of these securities are taxed at 10 percent (long-term) and 30 percent (short-term).

Any capital losses made in a particular year can be set off only against capital gains made in the same year. If set-off is not possible, these capital losses can be carried forward for a period of eight years, and set off against the capital gains of subsequent years.

### **Wealth tax**

Wealth tax is levied on non-productive assets whose value exceeds Rs. 1.5 million. Productive assets like shares, debentures, bank deposits and investments in mutual funds are exempt from wealth tax. However, the Government levies wealth tax on non-productive assets like residential houses, jewelry, bullion, motor cars, aircraft, urban land etc. Foreign nationals are exempt from wealth tax on non-Indian assets.

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<sup>45</sup> As per the latest budget proposals, July, 1996.



Net wealth upto Rs. 1.5 million is exempt from wealth tax and any amount in excess of this is taxed at a flat rate of 1 percent. In arriving at the net taxable wealth, any debt incurred in acquiring specified assets is deductible.

### **Tax Depreciation Rates**

Tax Depreciation rates as applicable for the accounting year ending March 31, 1996:

#### *Tax Depreciation Rates*

<b>Asset</b>	<b>Tax Depreciation Rate (%) allowed per Year</b>
Mainly Residential.	5 %
Dwelling units with plinth area not exceeding 80 square meters and hotels.	20 %
Others (includes all commercial buildings)	10 %
Purely Temporary structures	100 %
Furniture and Fittings	10 %
Special furniture and fittings in hotels, cinemas, etc.	15 %

Source: India Economic and Business Overview, Center for Monitoring Indian Economy.

It has also been proposed in the 1996 budget to allow depreciation in the case of fractional ownership of assets because of the need for joint financing of big, capital intensive projects by a consortium of financiers having fractional shares in the assets. In order to further promote efficiency in industry, it has been proposed that unabsorbed depreciation which was earlier allowed to be carried forward indefinitely will now be for a period of eight years only, in the same manner as business losses.

### **General Tax Incentives**

The Government offers many incentives to investors in India with a view to stimulating industrial growth and development. The incentives offered are normally in line with the government's economic philosophy, and are revised regularly to accommodate new areas of emphasis. The following are some of the important incentives offered, which significantly reduce the effective tax rates for the beneficiary companies.

Five year tax holiday for<sup>46</sup>:

- New industries in notified states and backward districts and for new industrial units established, in electronic hardware/software parks, 100 percent export oriented units and units in Free Trade Zones.
- As of 1994-95 budget, firms engaged in providing infrastructure facilities, roads, highways etc., can also avail of this benefit.
- Deduction of 30 per cent of net (total) income for 10 years for new industrial undertakings.
- Deduction of 50 per cent on foreign exchange earnings by construction companies, hotels and on royalty, commission etc. earned in foreign exchange.
- Deduction in respect of certain inter-corporate dividends to the extent of dividend declared.

India also has tax treaties with almost all the major countries of the world. Some of the withholding tax rates under different tax treaties are given below<sup>47</sup>:

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<sup>46</sup> Manual of Policy and Procedures Governing Industrial Approvals, Secretariat for Industrial Approvals, Ministry of Industry, Government of India.

<sup>47</sup> India- Economic and Business Overview, Center for Monitoring Indian Economy, 1996.

*Tax Treaty Rates with different countries*

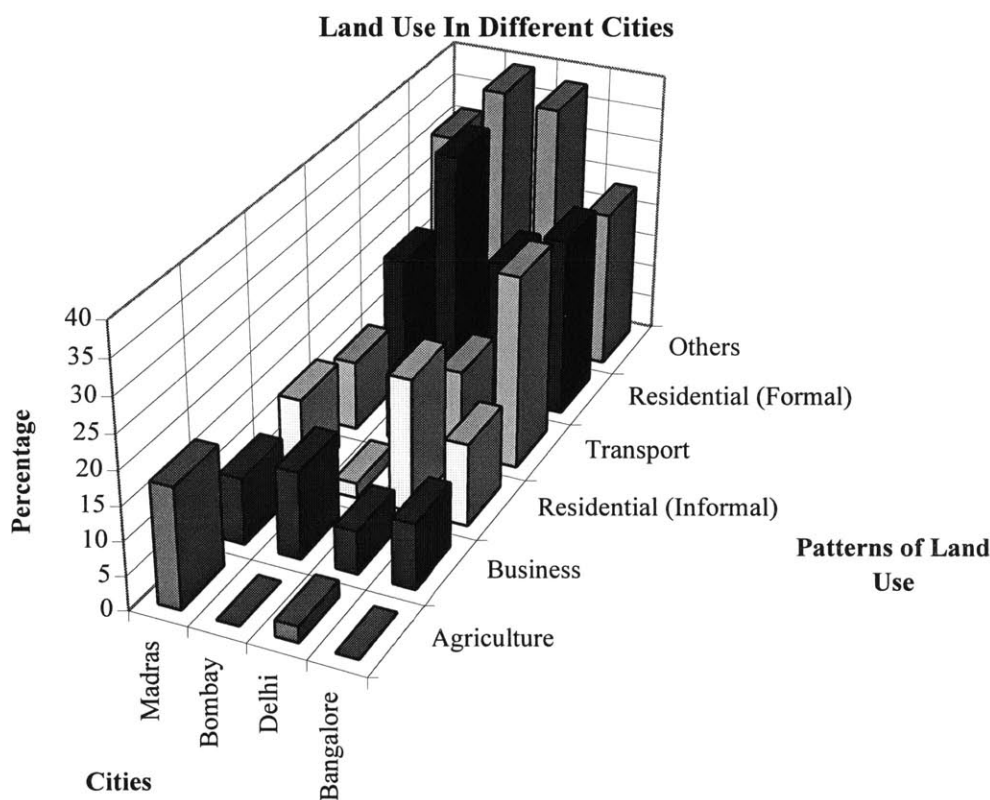
Country		Tax	Rates (%)	
	Dividend	Interest	Royalty	Technical Fee
USA	15/25	10/15	20/15	20/15
Mauritius	5/15	0	15	No Separate Tax
UK	15	10/15	30	30
Japan	15	10/15	20	20
Australia	15	15	10/20	No Separate tax
France	Not Mentioned	Not Mentioned	Not Mentioned	Exempt
Germany	15	10/15	Not Mentioned	20
Italy	Not Mentioned	15	Not Mentioned	Not Mentioned

## Chapter Four

### *Macro Analysis of Different Property Sectors*

Since 1991, India is in the process of economic reforms, the basic objective being to facilitate private sector entry into areas which had earlier been the domain of the public sector, and pave the way for the globalization of the economy. In this process, economic activities and financial rules have been significantly freed from regulatory controls, that existed in the past. This has led to tremendous growth in all sectors of the economy. It is in this perspective that this analysis of the current situation, in different property sectors, is presented. The impact of demographic development and growth of different sectors has already been discussed in earlier chapters. Land use patterns (%) for the four major cities is presented below:

*Land Use, 1993, in percent*



Source: SDS:UNCHS city indicators program, based on data on housing stock from official records of housing and urban development agencies, local government and city specific research studies.

Note: "Others" include public, semi-public & vacant land, industries, parks and playgrounds.

As is obvious from the above chart, a large portion of land in the major metros is owned by the government through public and semi-public institutions. This has led to the land markets being severely constrained, thus restricting new supply in all property sectors. The supply is also constrained because of the long development cycle which takes about two and a half to three years to get space into the market. Meanwhile, demand has been growing at a very healthy pace due to the surge in the economy, leading to sharp increase in the property prices in all cities. The prices have also been increasing due to the inflow of foreign capital from Non Resident Indians and the Multinational Companies.

Recently there has been a limited corrective action in the property prices of the central areas in Bombay and Bangalore. This is partly due to the liquidity crunch and tight money supply in the past 6 months in the Indian economy. This combined with the growth of the industrial sector has absorbed all the surplus funds of the companies. Simultaneously, rising interest rates, an uncertain political scenario and a downturn in the stock markets has led to a substantial decrease in the flow of funds to the real estate sector. But with all these conditions easing up now, property prices are again expected to go up.

For a longer term horizon the level of demand is expected to stay the same over the next few years, though it is expected to be redistributed to suburbs of the larger cities and to the second tier cities. There is going to be an increased inflow of capital into real estate in the next few years. The government has approved Rs 79 billion worth of foreign participated projects alone (See Appendix). This combined with other large scale domestic investment will also lead to an increase on the supply side, though it is not expected to be enough to cater to the huge demand base. With increased levels of transparency, a move towards the public markets for real estate, a well developed financial and property rights system, reforms in the land and rent laws, high levels of GDP, industrial production and population growth and a huge foreign investor interest in the Indian economy, the stage seems set for long term growth in the real estate sector.

### ***Housing***

The housing shortage in India continues to be daunting, comparative increase in the housing stock has not kept pace with the population growth and has also not been sufficient enough to arrest the existing shortage. In the past forty years housing has largely been a private sector and people's activity. The private sector has been the major source of funds providing 70-80 percent of total

investment in housing in the first five 5-year plans and 92 percent in the sixth and seventh plans. Creating a conducive environment for private sector investment was accepted as a policy objective, but was not adequately carried out at the policy formulation level. A private sector led housing program did not, therefore, take off, in the desired direction and at the required pace. The creation of housing related infrastructure assets and their maintenance was largely the responsibility of the local governments and to some extent the state governments, but a weak resource base and an unimaginative pricing policy made the pace of development very slow.

During the last two decades, housing contributed around 10 to 12 percent of annual gross capital formation and income from housing in GDP averaged around 5 percent. The restrictive factors in the lack of development of the housing markets are, as discussed earlier, lack of a proper operational environment, reflected in an inefficient land market, restrictive legislative provisions and limited access to financial resources. While the institutional housing finance system has expanded considerably in the last decade, its penetration levels in terms of the overall size of the housing market are still very low. The investment in the Housing sector has been increasing considerably over the last forty years as can be seen from the table below:

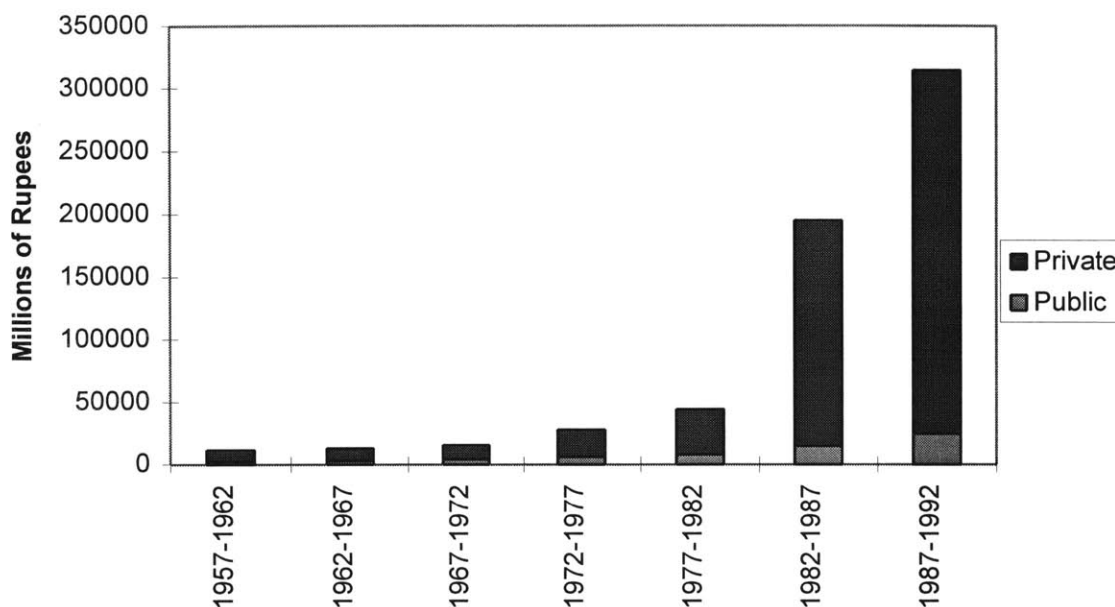
*Investment in Housing in Different Five Year Plans (in Millions of Rs)*

Plan Period	Public Sector	Private Sector	Total	% of Inv. in Housing to total Inv. in the Economy
1957-1962	2,500	9,000	11,500	34.00%
1962-1967	3,000	10,000	13,000	19.00%
1967-1972	4,250	11,250	15,500	15.00%
1972-1977	6,250	21,750	28,000	12.00%
1977-1982	7,960	36,400	44,360	9.30%
1982-1987	14,910	180,000	194,910	12.50%
1987-1992	24,580	290,000	314,580	9.00%
1992-1997	63,770+250,000*	NA	-	1.50% (Approximate)

\* Plan Outlay and Institutional Financing.

Source: Ministry of Urban Affairs, Housing Section.

### Investment in Housing



Housing costs have become prohibitive in the mega and metro cities and the larger towns. Housing indicators developed for the United Nations Center for Human Settlements clearly bring this out. House price for a median house is equivalent to 13 years of annual household income in Bombay, 12 years income in Delhi and 11 years income in Bangalore. The house price ranges from three to five years income for smaller and intermediate towns. The scenario in rental housing is pretty similar.

*House Price to Income ratio and House Rent to Income Ratio, 1993.*

City	Population (Million)	House Price to Income Ratio	House Rent to Income ratio
Bombay	10.26	13.38	0.31
Delhi	8.96	11.99	0.44
Madras	5.65	7.01	0.38
Bangalore	4.47	11.27	0.49

Source: SDS:UNCHS city indicators program, based on data on housing stock from official records of housing and urban development agencies, local government and city specific research studies.

The population in the major cities of the country has been growing at very high rates, and so are the number of households and dwelling units, as can be seen from the chart below.

*Growth of population, Households and Dwelling Units during 1981-1991:*

City	1981	1991	% Increase
<b>Greater Bombay</b>			
Population	8,243,405	12,596,243	52.80
Households	1,624,535	2,650,802	63.17
Dwelling Units	1,590,575	2,616,286	64.49
<b>Bangalore</b>			
Population	2,921,751	4,130,288	70.65
Households	522,369	828,867	58.67
Dwelling Units	515,599	824,022	59.82
<b>Delhi</b>			
Population	5,729,283	8,419,084	46.95
Households	1,133,171	1,690,233	49.16
Dwelling Units	1,017,754	1,619,467	59.12
<b>Calcutta</b>			
Population	9,194,018	11,021,918	19.88
Households	1,746,839	2,155,418	23.39
Dwelling Units	1,721,143	2,134,201	24.00
<b>Madras</b>			
Population	4,289,347	5,421,985	26.41
Households	834,288	1,139,438	36.58
Dwelling Units	822,216	1,130,455	37.49
<b>Pune</b>			
Population	1,686,109	2,493,987	47.91
Households	322,998	513,944	59.12
Dwelling Units	311,028	504,912	62.34
<b>Hyderabad</b>			
Population	2,545,836	4,344,437	70.65
Households	433,640	784,886	81.00
Dwelling Units	412,802	767,675	85.97

Source: Census of India, 1991.



The shortage in terms of minimum housing needs is about 5.0 million units in 1991, and this is projected to increase by 0.5 million units over the next six years. Total housing shortage was estimated at about 23 million units in 1991.

*Housing Stock and Housing Shortage for 1991, 1995 and 1997 (in million).*

	1991		1995		1997	
	Total	Urban	Total	Urban	Total	Urban
Population	846.3	217.6	905.7	249.7	937.7	267.5
Households	153.2	40.7	166.4	47.3	174.1	51.8
Housing Units	148.1	39.3	161.1	45.5	168.5	49.8
Housing Shortage*	22.9	8.2	31.1	8.5	33.0	9.5

\* Housing Shortage includes numbers for replacement and decongestion.

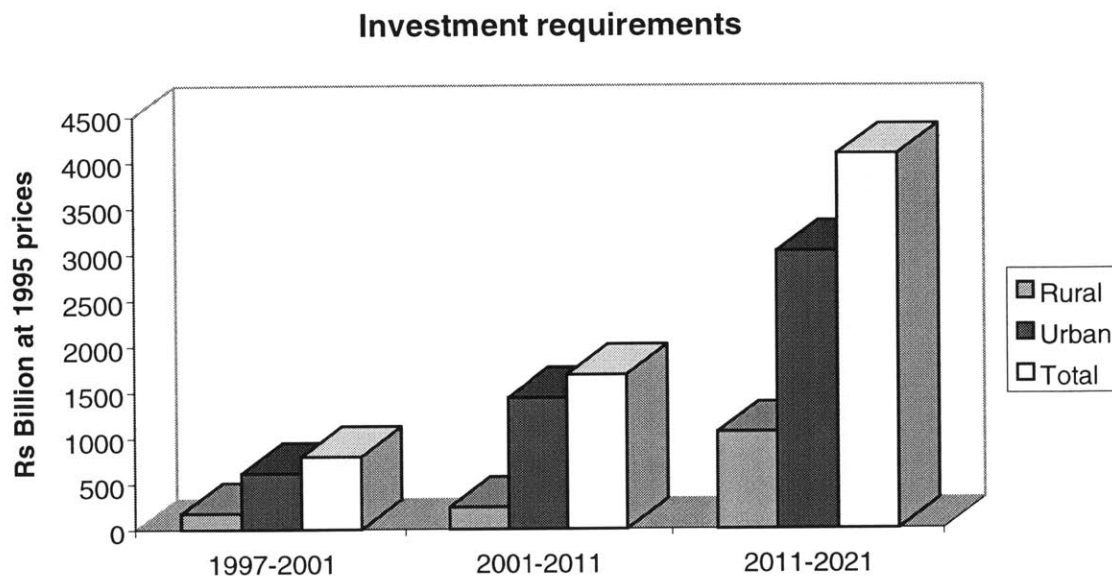
Source: Census of India, 1991, National Building Organization and Society for Development Studies.

Private developers have mainly been operating in the major metropolitan cities. In recent years they have also moved out to smaller and medium cities where more land is available and the entry costs are much lower, but offer high returns due to the large demand base. Private developers have also played an important role in the development work for individual plot owners and cooperative societies. Some have even diversified into the housing finance sector to provide a total package.

From an investment perspective, if each household was to have a unit, it is estimated that 140.1 million units would be required during 1996-96 to 2020-21, averaging 5.60 million units per annum. In a shorter term perspective, the requirement for 1996-97 to 2000-01 is estimated to be at 17.1 million units or 3.42 million units per annum. This would require an investment of over USD 200 billion over the next 25 years, and USD 25 billion over the next five years, at 1995 prices.<sup>48</sup> It is amply clear that this kind of investment is difficult to generate domestically. Hence, the industry view is that the government will look towards the foreign investors to bring in the capital and also newer technologies to increase the flow of housing stock into the market. This represents a tremendous opportunity for the foreign investors, it is a market with a huge demand base and urgent need of financing for developmental activities.

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<sup>48</sup> Society for Development Studies estimates.



Source: Society for Development Studies' estimates.

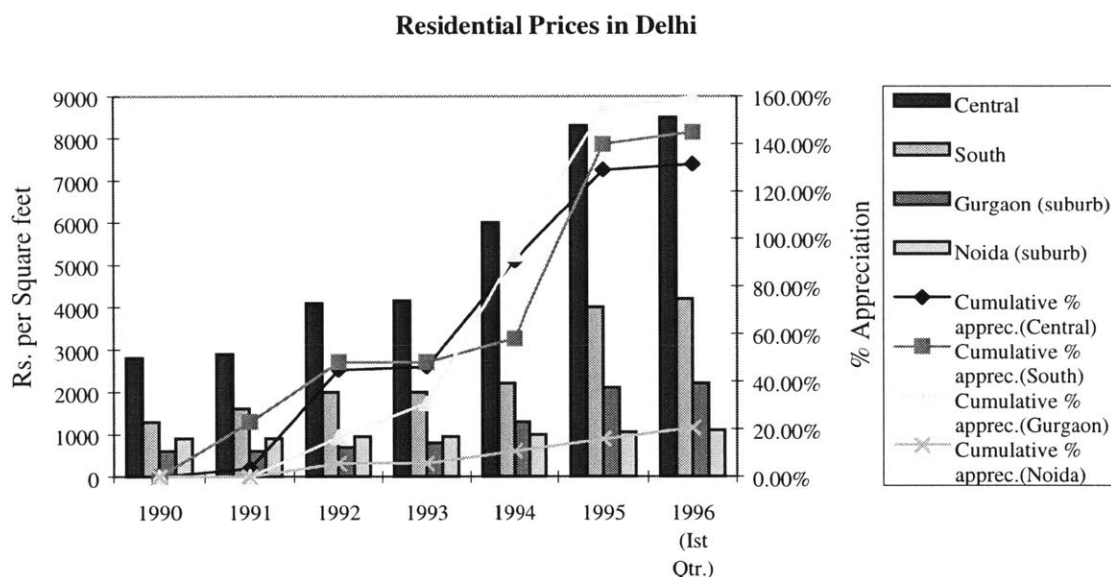
More recently, there has been a move towards decongesting the cities and development of the suburban areas. A number of private developers have taken the initiative towards this and large scale townships have been cropping up on the outskirts of most major cities. The quality of development in these townships is much higher with better infrastructural facilities and higher quality of construction. The consumers have lapped up the space in these areas and they have witnessed large scale appreciation in prices.

### **Market Focus- Delhi, Bombay, Bangalore**

#### **Delhi**

Development in Delhi is totally controlled by a single nodal government agency, the Delhi Development Authority (DDA). Certain areas have also been demarcated for use of Housing Cooperatives, but they also have to approach the government for allotment of land. Against a current shortage of half a million units and a demand for 80,000 units a year, DDA on its part has rarely managed to deliver more than 8000 units per annum. In addition the quality of construction of these units leaves a lot to be desired. Being the capital of the country, the city is also home to a large population of government employees, occupying a large percentage of residential space at subsidized rents, hence limiting the availability of quality space.

In addition Delhi has a multiplicity of authorities for maintaining municipal services and housing infrastructure, the New Delhi Municipal Corporation (NDMC), Municipal Corporation of Delhi (MCD), Urban Arts Commission and DDA all control different aspects of the development process and often act at cross purposes, thereby implicitly pushing up the cost of real estate development. The following chart gives the movement of property prices in the major areas of Delhi and its suburbs over the past seven years.



Source: Richard Ellis India and Housing Development and Finance Corporation.

With construction activity restricted in the central area (popularly known as Lutyens' Delhi)<sup>49</sup> and prices in the premier southern areas escalating tremendously, the residential demand has been gradually shifting to the suburban areas of Gurgaon (to the south) and NOIDA (to the east). Out of the two Gurgaon has seen more development and influx of buyers due to its quick access to South Delhi, proximity to the airport, better quality of development and the progressive image of the state of Haryana, under whose jurisdiction it falls. Due to the high prices in the city, a number of corporates have also located their employee housing in these areas, further fueling demand. The prices in some of these areas have appreciated by about 1200 percent in the past decade. This

<sup>49</sup> The city of New Delhi was designed by Sir Edwin Lutyens, a British architect, in 1920-30's.

upward movement of prices is expected to continue in the near future due to lack of supply and restriction on the Floor Space Index (FSI)<sup>50</sup> to 2.5 in the city areas.

In an effort to decongest the capital city the government has formulated the National Capital Region (NCR) Plan. The NCR strategy proposes induced development of self contained integrated townships concentrated around core economic activities in the vicinity of the capital. It also plans to achieve population redistribution by inducing out-migration of selected categories of squatter households from Delhi to these new townships. It is aimed at developing intermediate cities in the capital region with improved housing conditions and upgradation of infrastructure facilities. The government recently allocated Rs 73.5 billion for the region to integrate various mass transport systems being planned in the national capital which include a perimeter expressway, elevated expressway on the ring road surrounding the capital, feeder transit system and a north-south underground corridor.<sup>51</sup> The NCR plan has also failed to take off in a big way because of tardy policy implementation and legislative problems with the surrounding state governments under whose jurisdiction a large amount of the land for the proposed NCR falls.

### **Bombay**

The city of Bombay consists of what used to be seven islands but now form a peninsula due to the extensive reclamation's made from the sea over the years. Even with all these reclamation's the city remains highly constrained for land. Property prices have been escalating in the city and its suburbs over the past six years due to many of the reasons that exist in the Delhi market. Being the commercial capital of the country there is added pressure on the city with a concentration of business here.

The real estate of the city is managed by Bombay Metropolitan Regional Development Authority (BMRDA) which coordinates the development of the entire metropolitan region, Bombay Municipal Corporation which manages the old city area and City and Industrial Development Corporation (CIDCO) which manages the twin city of New Bombay. Again the multiplicity of agencies and the lack of coordination between them has led to a lack of quality development. New Bombay, which was originally planned to decongest the old city has become another suburb adding

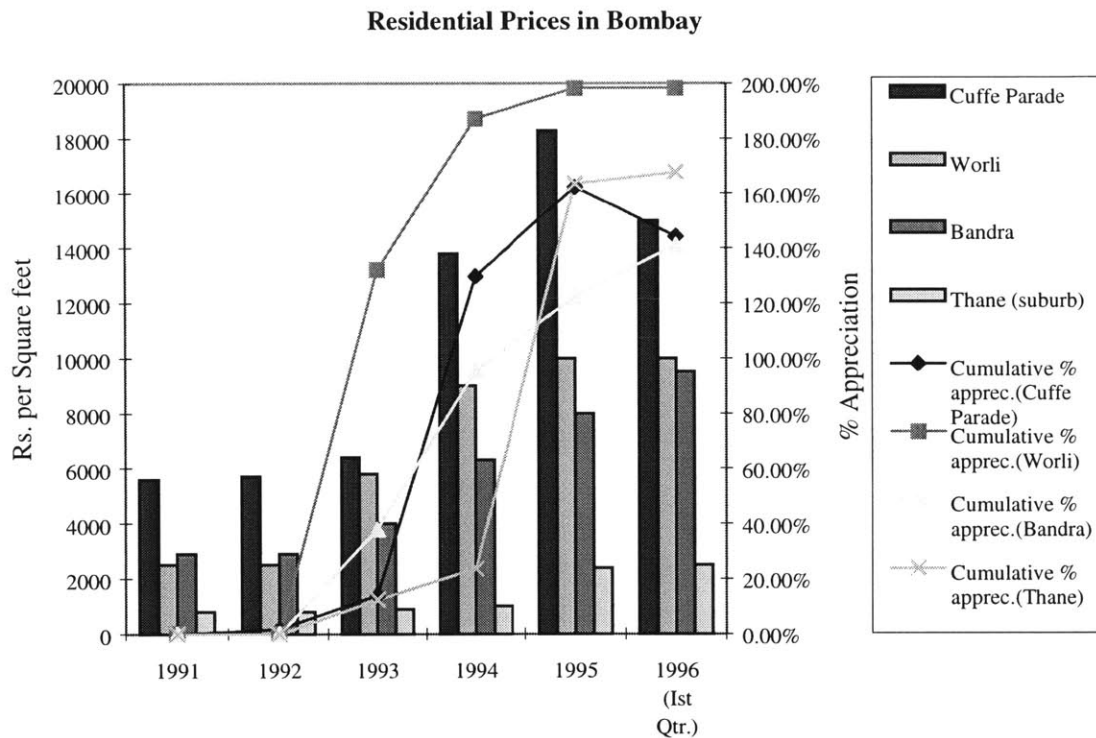
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<sup>50</sup> An FSI of 2.5 regulates that the developer can build upto 250 percent of the total land area of the plot.

<sup>51</sup> Financial Express, February 26, 1996.

pressure on to the city. Similarly tremendous growth in the northern Virar-Vasai belt has added pressure on to the city. An important feature in the growth of Bombay has been a very efficient urban rail transport system. But with increased population pressure there is a need to expand this system further.

With FSI restricted to 1.33, prices in the city and the suburban areas have been escalating very fast with some areas showing cumulative price appreciation of 200 percent over the past five years.



Source: Richard Ellis India and HDFC.

Recently there has been a downward trend in the prices in the main city areas. This is due to a number of factors. First being the general liquidity crunch in the market. The simultaneous development of a new business hub in the Bandra-Kurla area and the town of New Bombay has put the pressure off the CBD (Nariman Point). Large scale residential development in the northern parts of the city have further acted as catalysts in reducing prices in the central areas. A number of companies are also moving their corporate head quarters out of Bombay due to the high real estate costs which have become difficult to justify. There are nearly 60 mills in midtown Bombay occupying 2 million square feet of land. This area has been earmarked for residential and

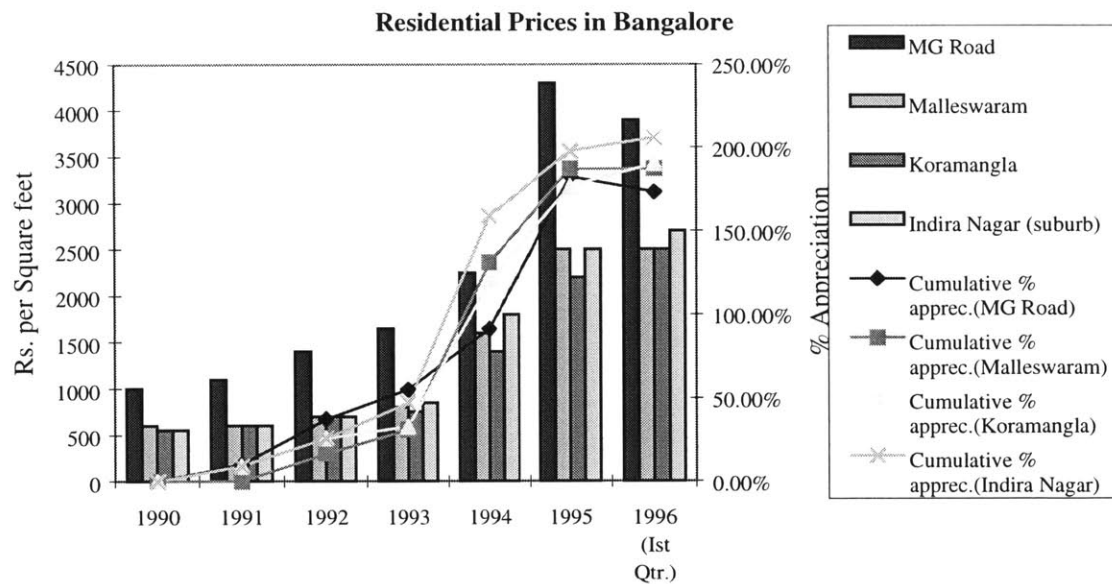
commercial development. The release of this land into the market is going to substantially increase the supply of real estate, this should put a downward pressure on the market. Another scheme of the state government aimed at slum redevelopment is expected to further decrease prices. But most market watchers see this as a temporary correction. Any new supply from the mill area and slum area redevelopment will take at least five years to come into the market. Till then an upward pressure on prices is likely to be maintained.

### **Bangalore**

The capital of Karnataka state is one of the fastest growing cities in Asia. It is now also known as the “Silicon Valley” of India due to the concentration of software and computer related companies in the city. In a recent survey of corporate executives and business school students, Bangalore was rated as the favorite city to live in. This is primarily due to its more cosmopolitan environment, higher quality of manpower, relatively cheaper real estate, low level of pollution, dust free climate, law and order and state government support. There is also a large base of high technology institutions and colleges which provide the manpower for the high-tech companies.

Due to the pragmatic attitude of the state government the development process is believed to be bit easier than in Delhi or Bombay. Increased influx of MNC's and local corporates and a high level of migration from other cities has led to large scale appreciation in residential property. Capital values have gone up by over 200 percent in some areas during the last five years.

But this scenario is changing fast because of the high pressure on the city's infrastructure and the development of second tier cities like Pune, Hyderabad and Cochin. Power is in perennial short supply, water shortages are becoming endemic and the city has only 17 percent of its area covered by roads leading to increased traffic congestion and pollution. There has been a stagnation in property prices in the last quarter of 1995 and the first quarter of 1996. The government has recognized these problems and plans to invest Rs 20 billion in infrastructure over the next ten years. A bulk of this investment will go towards establishing of the mass rapid transport system (MRTS). In a shorter term perspective nobody expects the prices to come down as there is still a huge shortage in stock which has failed to satisfy the existing levels of demand.



Source: Richard Ellis India and HDFC.

### *Office Sector*

The office market in the country is small in terms of the total stock of space. Although no data is available about the existing stock, the market narrows down to small pockets of a handful of buildings in each city, if one were to take out the government occupied space. This has been so because the Indian companies have tended to use all types of space as office space. Hence you have a large number of companies operating out of their factories itself or out of residential areas. The stock is also restricted due to the artificial supply side shortage that has been created by the archaic rent control and urban land ceiling laws and strict zoning regulations, which have been discussed earlier.

The sharp increase in corporate demand for quality office space has been a direct result of the government induced economic liberalization policies. This has resulted in the entry of a large number of multinational corporations and expansion of the Indian corporate sector and sharp escalation's in capital values for commercial office space.

A big problem with office buildings is that they have multitude of ownership (estimated in some cases at 200 parties per building) which makes them virtually unmanageable owing to the undeveloped strata-title management legislation currently in place. This also stems from the lack of

a leasing market which could not develop due to the decidedly pro-tenant rent control laws. There are only two known institutional quality buildings in the country that are owned by a single owner. But with the entry of MNC's and Indian corporates there are signs of a healthy leasing market developing despite the problems of the rent control act. Being higher credit tenants, the owners are more open to leasing the space to the larger companies than to smaller companies or individual tenants. These companies in some cases even provide letters of credit to the owners which they can use in case the company refuses to move out at the end of the lease term. There is also a large amount of black money involved in these transactions due to the high levels of taxes on rental income, with some of the owners even requiring the MNC's to pay them in hard currency in foreign bank accounts. On the other hand it is virtually impossible for single tenants to obtain space in the office market.

With the use of cellular phones and wide area computer networks picking up steam and the prohibitively high cost of real estate in the downtown areas, there has been a move by a number of companies to shift offices out of the CBD areas to suburban office developments in the major cities. The quality of office space and the infrastructure is better in newer developments and they are available at comparatively lower prices. The companies prefer to operate smaller representative offices in the downtown, with the bulk of their office space in the suburbs where the prices are much lower. Some companies like Coca Cola, Procter and Gamble, Citibank and ANZ Grindlays have shifted their entire offices out of Bombay to the suburbs of Delhi, Bombay, Bangalore and Madras. This has led to a stagnation and in some cases a fall in the property prices in the central areas of some of the cities.

### **Market Focus- Delhi, Bombay, Bangalore**

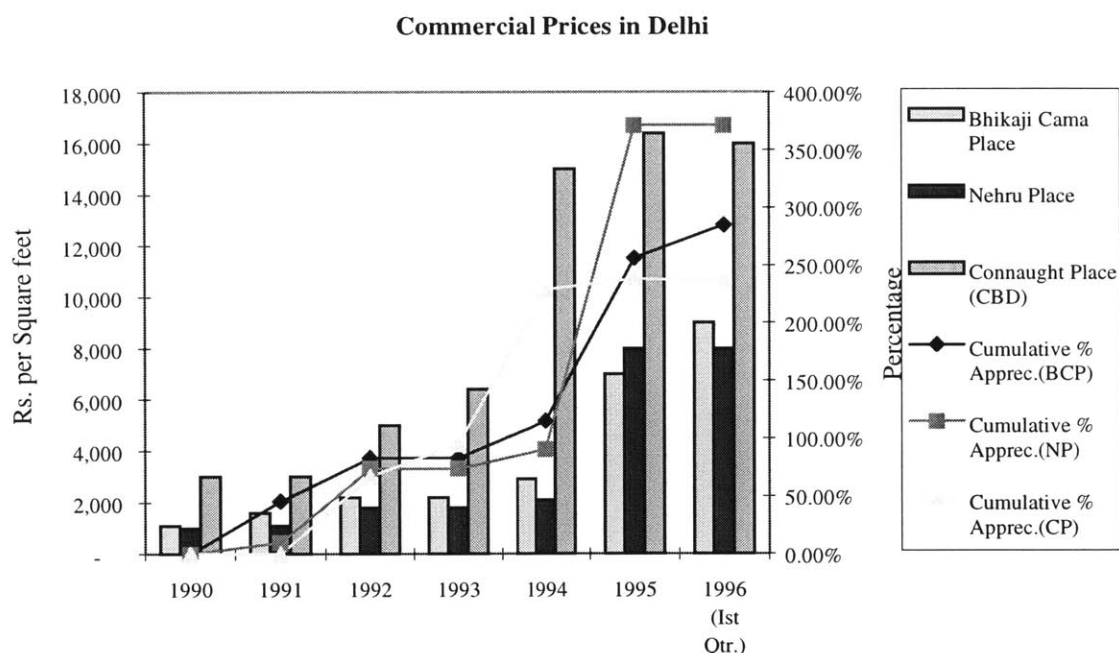
#### **Delhi**

Delhi, like all other metros has witnessed a sharp increase in the rental and capital values of office space since 1990. Like most capital cities it has a large concentration of government offices and employees and close to 28 percent of the total workforce is employed by the government. However the rate of growth of government employment has been more than even the rate of population growth. As a result, large areas of prime commercial office space are occupied by this sector, placing an additional strain on the already limited office space in the CBD. Thus along with the



entry of MNC's and larger needs of the Indian corporate sector, a supply side shortage, the city also has to cope with the needs of the government sector.

In an effort to decongest the CBD, the government has restricted the Floor Space Index (FSI)<sup>52</sup> in the CBD to 1.5. Coupled with the restrictive guidelines laid down by the Urban Arts Commission regarding permitted height of new construction, this has effectively curtailed to a large degree any future addition of office space in the area. There are only three new office buildings in the pipeline which are not likely to be ready for occupation before 1997. The current vacancy rates in the CBD are below 2 percent. The chart below shows the movement of commercial property prices in Delhi over the last six years.



Source: Richard Ellis India and HDFC.

Delhi has been unable to address the resulting imbalance in supply and demand. The growth in demand has remained unchecked with insufficient measures taken to allow for supply increases. In the two major commercial areas of central and south Delhi, office space remains extremely limited due to the non availability of land combined with strict zoning restrictions on land use. All MNC's,

<sup>52</sup> FSI of 1.5 allows the developer to build 150 percent of the total land area of the plot.

banks as well as most major Indian companies are concentrated in the Connaught Place (Central Delhi) area where zoning allows 100 percent commercial usage.

Whilst Connaught Place is likely to remain the city's key business and financial hub, the long term trend is towards office decentralization. A number of companies have either moved or shown an inclination to move to the suburbs. DLF Ltd., one of the largest developers in India has developed a corporate park on the outskirts of Delhi where it is selling developed plots for office building directly to the companies. The companies then come in and construct office buildings either on their own or with the help of the developer itself. Efforts have also been made by the government under the NCR plan to relocate some of the non-essential and the public sector corporations' offices to the outer parts of the city by developing alternate commercial areas. Although the suburbs are priced 60 to 70 percent lower than the CBD, infrastructural constraints and accessibility problems have curtailed a mass movement to the suburbs, which would otherwise be expected in such a scenario.

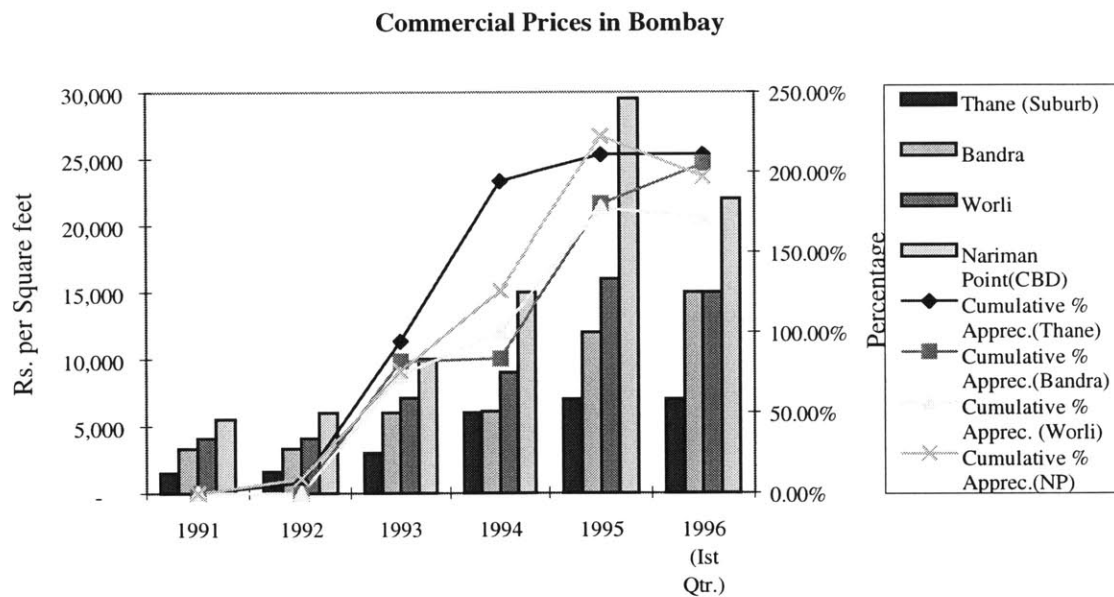
From a longer term perspective, there is always going to be a requirement of space in the CBD from the MNC's and the larger Indian companies, and demand here will be constant. However due to acute shortage of space, escalating values and infrastructure constraints, most companies are likely to base their larger offices in the suburbs and maintain only a token presence in the heart of the city. The tremendous price increases which had taken place earlier would probably rationalize to some extent due to the availability of commercial space outside the CBD, but the over all trend should remain upwards for the next few years based on the increasing popularity of Delhi with the corporates.

Due to the continued pressure on the supply of office space within the CBD, unauthorized usage of residential and institutional use buildings as office space is rampant in the outlying areas. However due to the uncertain legal status of such space MNC's are becoming hesitant to use such space. There is a limited supply of legitimized commercial office space in the residential areas outside of the CBD which can offer higher quality space at more realistic rental levels. However there are problems with the infrastructure available in these buildings. It is anticipated that there will be significant growth potential for this legitimate use of commercial property. In addition, as mentioned earlier, the companies are currently examining areas outside the city (Gurgaon and

NOIDA) but within the National Capital Region (NCR) which are close to the developing industrial areas. These represent the biggest growth potential for office space in the medium to longer term.

## Bombay

Commercial property prices which had been shooting up over the last five years in Bombay, have stagnated and actually fallen in some areas, in the last six months. The earlier increases had been fueled by demand from the MNC's, NRI's and expanding domestic Indian companies on one hand and by the acute shortage of quality commercial office space in the city. This had led the property prices to jump to unrealistic and unsustainable levels and there was a need for the corrective action in the market which happened over the last six months. The following chart presents the movement of capital values for office space in Bombay over the last five years.



Source: Richard Ellis India and HDFC.

The reasons for stabilization of the property market are many, the prime being the liquidity crunch in the Indian economy, increase in the supply of office space in the suburbs and the uncertain political conditions. Also, it had become extremely difficult for the new MNC's and FII's entering the market, to justify the high prices of real estate to their head offices abroad. Hence they increasingly started going for either the suburbs or for different cities.

With no new developments coming up in the CBD area for the next few years till the land laws witness substantial change, all the activity is expected to be centered in the Bandra-Kurla complex in suburban Bombay and the twin city of New Bombay. The Bandra-Kurla complex is a 370 hectares area which has been earmarked for future development with a series of well planned office and residential blocks along with the necessary infrastructural facilities such as roads, trains and telecommunications. This area is located between two national highways and is only 15 minutes from the International airport. The area is being developed as an alternative to the CBD with setting up of an International Finance and Business Center (IFBC) as the nerve center for the entire complex. It is a part of the plan to put Bombay as a major financial center on the world map. The National Stock Exchange (NSE) is soon to start full scale operations from the IFBC linking it to the other major stock exchanges of the world. Most of the major financial institutions, banks, the diamond bourse and leading Indian companies have purchased land there.

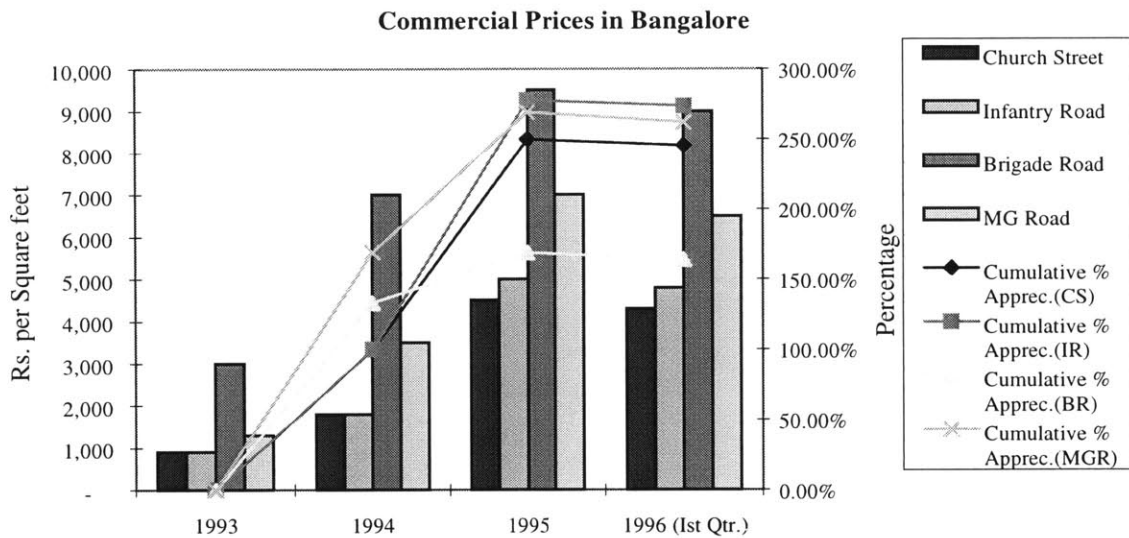
New Bombay is the twin city 35 kilometers north of Bombay. Many large infrastructural projects including a new port, airport, rail connections in addition to the planned office and residential developments are coming up. The major commodity markets have already been shifted there from south Bombay. Mass transportation by sea to the new city is being actively considered by both the government and the companies who want to be near their manufacturing bases in the developing industrial area around New Bombay. Costs there are significantly lower than in South Bombay, but currently quality housing is a problem and a lot will depend on the timely provision of infrastructural facilities.

### **Bangalore**

The Silicon valley of India has seen extraordinary growth in the past few years mainly due to the economic liberalization policies of the central government and the pragmatic attitude of the state government. The demand for office space in Bangalore is coming from the new MNC's entering India, existing MNC's and Indian companies expanding operations and new Indian companies entering the market, specially in the software and computer related industries. The city is particularly attractive to high tech companies because of its large base of high technology industries and easy availability of trained manpower to manage and run high tech companies. There are a large number of engineering and science colleges in and around Bangalore which provide the manpower for institutions and companies like Indian Institute of Science, Hindustan

Aeronautics Ltd., Indian Space Research Organization, Indian Telephone Industries, Texas Instruments, Hewlett Packard and a host of software and computer products companies.

The CBD which originally was a residential area has over time seen tremendous building activity and has developed into a commercial area. This consists essentially of a handful of buildings on MG Road and Brigade Road. Capital and rental values had nearly tripled in the last few years but have seen some stabilization in the last quarter of 1995. The chart below gives the movement of capital values for commercial office property in Bangalore over the last few years.



Source: Richard Ellis India and HDFC.

It is estimated that the CBD currently has a vacancy rate of 15 percent and due to the rapid construction activity, an estimated 2.5 to 3 million square feet of office space will be available in the next few years. Along with this the user has become very quality conscious, hence developers churning out sub standard properties are going to have hard time selling in the market. In addition, the Software Technology Park being developed on the outskirts of the city by TATA's (the largest Indian business house) and a consortium of Singapore investors and the area around it is expected to take the pressure off the CBD and develop as an alternate commercial hub for the city. Hence for the longer term although the demand is going to be there it will be focused on quality office space and the standards of asset and property management are expected to improve substantially.

### ***Hotels and Tourism Related Real Estate***

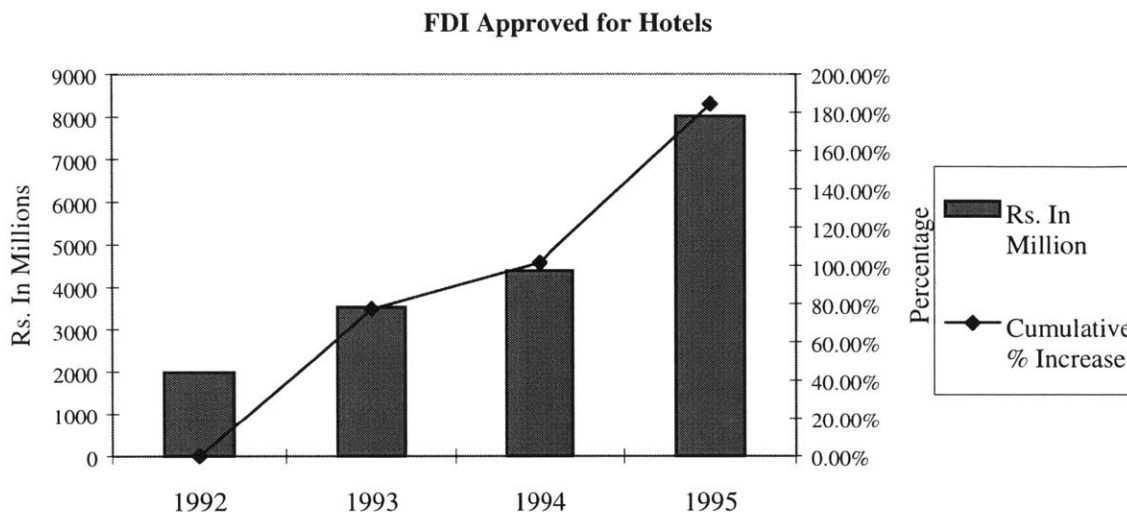
India offers great potential for tourism due to its rich and vast cultural heritage and an enormous land mass which covers everything from mountains to beaches to deserts, but the rapid development of this sector has been constrained by lack of adequate infrastructure and facilities. Even with these limitations tourism has been growing at a rate of 9 percent per annum and is the single largest net foreign exchange earner for the country. At present India has about 49,000 approved hotel rooms in the major cities, as against a requirement of about 89,000 rooms which is expected to reach 125,000 rooms by the turn of the century.<sup>53</sup> There are only 31,000 rooms in the pipeline, so it is going to fall short of demand by about 90,000 rooms. According to tourism industry analyst Rabindra Seth, Delhi itself is 10,000 rooms short of demand and this has become a major bottleneck for the development of tourism.

India's 95 million domestic tourists are only aggravating the rooms shortage. Besides hotels, there is also a hardfelt need for development of other tourism related facilities providing leisure, entertainment, convention facilities etc. This is also one of the few sectors of the real estate industry where there is a tradition of public companies, the top four hotel chains of the country are all publicly traded companies. Hence there is a level of transparency in this sector which is absent from most other real estate sectors.

Recognizing the need for attracting investment into this sector, the government has declared it to be a 'high priority industry'. Automatic approvals for foreign equity up to 51 percent as well as foreign technology agreements are available from the RBI subject to fulfillment of certain parameters. This includes restaurants, beach resorts and other tourism complexes providing accommodation catering and convention facilities. The Tourism Finance Corporation of India has been set up to render financial assistance to the private sector for construction of hotels. Large hotel projects are financed by all India financial institutions like the Industrial Development Bank of India (IDBI), Industrial Finance Corporation of India (IFCI) and Industrial Credit and Investment Corporation of India (ICICI).

Other assistance by way of capital subsidies, tax exemptions and special foreign exchange facilities is also available. Under the Export Promotion Capital Goods (EPCG) scheme, import of capital

equipment by hotels, for which payments are made in freely convertible currency, is allowed at a concessional rate of customs duty of 15 percent. Due to these concessions granted by the government, Foreign Direct Investment in this sector has grown considerably over last four years.

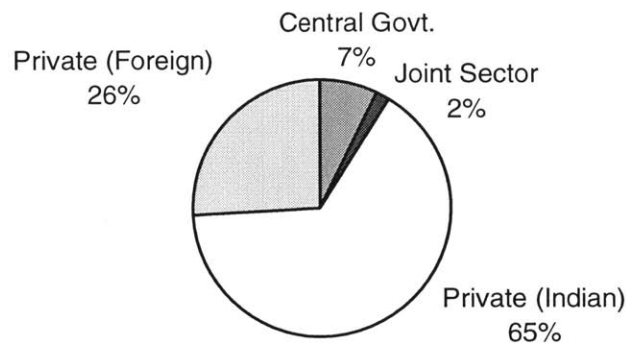


Source: Monthly Review, Center for Monitoring Indian Economy, May 1996.

In a paper titled 'National Strategy for Tourism Development', the Department of Tourism has proposed an investment of Rs 313.5 billion on tourism and other related infrastructure. Of this the central government is expected to pump in Rs 134.5 billion, with Rs 122 billion coming from the financial institutions and the state governments coming up with Rs 12.5 billion. The private sector is supposed to invest the remaining Rs 44.5 billion. The department has also proposed a number of financial, fiscal and import concessions for the faster and integrated growth of tourism and related infrastructure. A total of 79 projects for hotels and tourism have been approved by the government envisaging a total investment of Rs. 80.51 billion. The break up of investment from different sectors is given below. A detail list of the approved foreign direct invested projects in the hotel sector is given in the Appendix.

<sup>53</sup> National Strategy for Tourism Development, paper by the Department of Tourism.

### Investments approved in Hotels

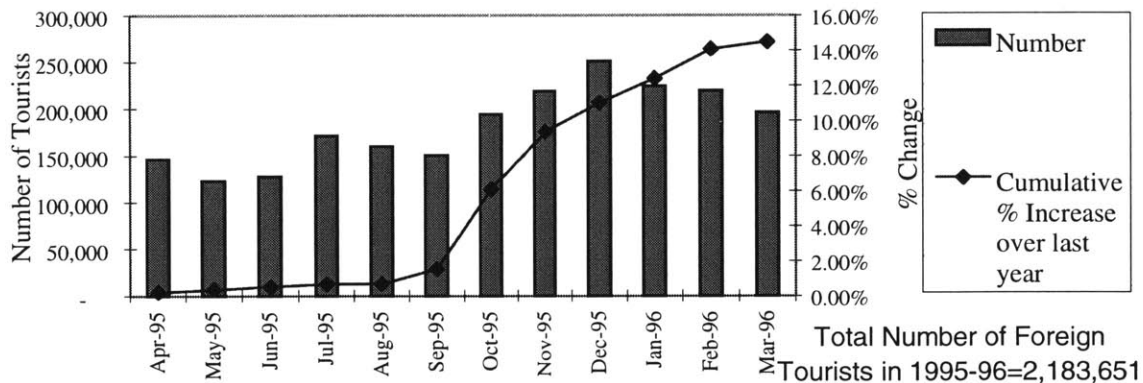


Total Investment Rs. 80.51 Billion

Source: Center for Monitoring Indian Economy, Survey of Investment Projects, May 1996.

In 1995 India attracted 2 million foreign tourists, the Department of Tourism aims at attracting 5 million by the turn of the century. Overall the inflow of number of tourists increased by 14.49 percent over the previous year. Average per tourist earning for January-April 1996, was USD 1,354 against USD 1,247 for the same period in 1995.

### Foreign Tourist Arrivals



Source: Monthly Review, Center for Monitoring Indian Economy, May 1996.

With the occupancies looking up hotel sector stocks and their profits are rising too. Liberalization has benefited the hotel companies in two ways; there is increased overseas traffic both on business and leisure and with local salaries on the uptrend, disposable incomes of Indians have also increased considerably. Average occupancies have grown by 12 percent in 1995-96, average room



tariffs grew by 25 percent and operating profit margins (OPM) grew by 34.52 percent over the previous year. Some of the properties of these companies are supposed to have occupancy levels of over a 100 percent.<sup>54</sup> The companies have also benefited by the 12 percent depreciation of the rupee against the dollar. The performance of these companies beat the Sensex<sup>55</sup> by 19 percent in 1995. With no significant capacity additions likely over the next two years in the metros, the companies are expected to increase their tariffs further to boost incomes.

### ***Retail***

Being the second most populous country in the world, India is one of the largest consumer markets in the world. There are 3800 towns and cities in the country which are home to 217.6 million people as of 1996. Due to the lack of infrastructural facilities across the country it is a very scattered market. Although urban areas have high population density there is very little concentration in the retail trade. The vast population is serviced by 3.3 million independent mom and pop type of stores, of about 200 to 500 square feet each. Of these 1.1 million shops are in the urban areas. Supermarkets have started making their presence felt in the large cities like Bombay, Delhi, Bangalore and Madras, during the last 5 to 8 years. However, even these tend to be relatively small in size, and their contributions to retail sales volumes are negligible.

Most corporations rely on a chain of exclusive distributors, wholesalers, semi-wholesalers and retailers, to service consumers with their products. The manufactured goods are stored in warehouses, scattered across the country. From the warehouses, goods are transported to dedicated distributors. The distributors, in turn, service the retail trade at regular intervals, depending on the type and speed of movement of the product in the market. However crude this chain of distributions seems, it is believed to be one of the most efficient systems in the world. It ensures availability of products even in villages with a population as low as one hundred people. It is also said to be highly cost effective.

The aggregate cost to the company, between the warehouse and the retailer, is about 5 to 10 percent for consumer products.<sup>56</sup> Most distributors earn a margin of 5-10 percent on fast moving

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<sup>54</sup> Interview with Arvind Khanna, Richard Ellis India.

<sup>55</sup> Bombay Stock Exchange Sensitive Index.

<sup>56</sup> From a paper presented, by Rajendra H. Aneja (General Manager- Hindustan Lever), at the Kellogg Graduate School of Management, Northwestern University, Chicago.

consumer goods. Their total costs are at about 3-5 percent. Hence the effective margin works out to be about 2-4 percent. The fulcrum of the distribution apparatus are the wholesalers. They pioneered distribution of products in the country and have immense knowledge of the local markets and trade structures. They number around 300,000 in the urban areas and 400,000 in the rural areas. The companies themselves are able to service only 500,000 to 700,000 stores through distributors and their field force, the rest are serviced by the wholesalers and semi-wholesalers.

During the last decade retail outlets have grown at a rate of 5 percent in the urban areas and 10 percent in the rural areas. Outlets have been increasing in size and number, due to the increased availability of branded and packaged products. Between 1996 and 2005, retail outlets are expected to grow by 6 percent in urban areas and by 12 percent in the rural areas.<sup>57</sup> This means a total of 1.4 million stores in urban and 3.5 million stores in the rural areas, by the year 2000. This increase it is believed, will be fueled by increasing income and spending levels and demand for a wider variety of products.

The growth in supermarkets has been slow due to the low levels of per capita income and extremely high prices of real estate in the larger cities. Another reason for the slow growth of supermarkets in India is the high cost of overheads. A study done by McKinsey and Co. shows that of every Rs. 100 spent in a department store, Rs 30 is spent on overheads like rent, labor and utilities. In a supermarket the overheads are Rs 20, the warehouse club spends only Rs 7 out of Rs 100. However, the Indian corner store spends only Rs 3-4 on over heads. This disparity in fixed costs and overheads has hindered the growth of supermarkets. These differences are expected to decrease with the advent of professional retailers and retail developers who can play upon the synergy created by clustering of shopping facilities.

Within this system of retailing there is a tremendous potential for concentrated shopping facilities. The next decade should see the emergence of the professionally qualified retailer and growing demand for the concept of supermarket retailing. There is a growing awareness in the retailing business, of the importance of good infrastructural facilities in terms of the shopping areas. The general consensus seems to be towards the Wal-Mart model of wholesaling and retailing. The demand is predicted to develop for stores, around 30,000 square feet to a 100,000 square in size.

The beginnings of this demand is already being seen in cities like Delhi with large scale retail malls coming up. Ansals Plaza is one of the latest retail facilities coming up, in an integrated urban complex which consists of a five star hotel, cultural center, sports complex and guest houses. The construction for the complex has already started. It is an 80,000 square feet enclosed mall with the latest facilities. The developer is selling space in this mall at the rate of Rs 24,000 per square feet (approximately USD 700 per square feet) and has been able to pre-sell 40 percent of the space even before breaking ground. Similarly, the Housing and Urban Development Corporation (HUDCO) has developed an enclosed super market, within a mixed use complex of 200,000 square feet, which is being sold at Rs 15,000 (around USD 450) per square feet.

Retail is expected to be a major area of growth due to a number of reasons. People now have access to information and products because of the satellite television boom in the region, about 570 million people now have access to television in the country. Correspondingly income and spending levels have been rising, resulting in a consumer class which demands the best in the world.

### ***Industrial***

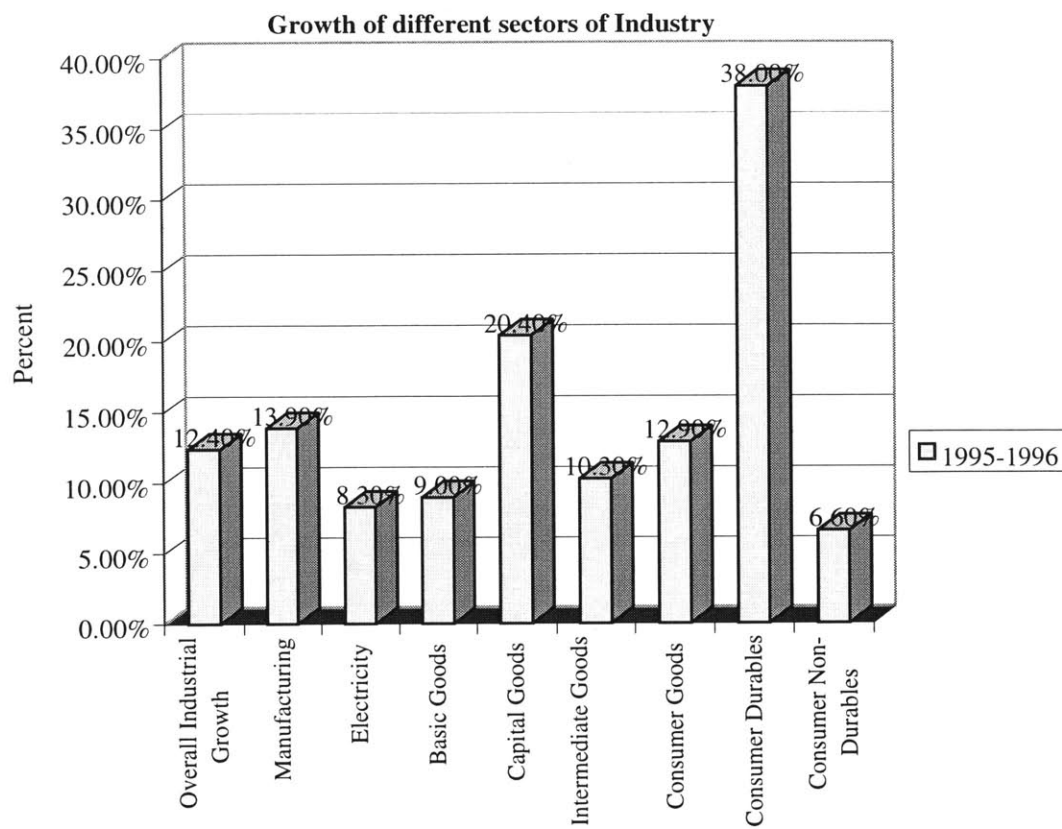
This is the sector that has enthused the investors the most, primarily due to the government's open policies concerning investments in industrial real estate. The industrial sector has been booming over the past five years with growth in industrial production touching 12.4 percent for 1995-96.<sup>58</sup>

Some of the sectors like software have even witnessed extraordinary growth rates in excess of 50 percent over the last few years. The government has opened up 35 high priority sectors for foreign investment and is making available a number of incentives for the investors. The phenomenal growth has been the result of foreign investment flow and the surge in the domestic industry. The corporate sector has been showing a robust growth over the last few years.

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<sup>57</sup> *ibid.*

<sup>58</sup> Economic Survey, Government of India, July 1996.



Source: Economic Survey, Government of India, 1996

But defying the logic of free enterprise, the factor markets of land and labor are yet to be freed. As a result corporates are a bit constrained in their attempts to respond to changing market conditions. They cannot get rid of the excess land due to the urban land ceiling act, hence freezing a substantial amount of resources for them. As mentioned earlier the government has acknowledged this as one of the key areas where reforms could lead to tremendous expansion of resources and jobs.

Traditionally industrial real estate has primarily consisted of built to suit properties. The developers had not caught on to the concept of developing industrial parks for use by different companies. Thus a company requiring industrial space would go out and acquire land, either on its own or with the help of the government, and then engage different agencies like the planners, architects, engineers and contractors to carry out the work for them on a contract basis. The company whose core business was something else, in effect, became the developer for its needs.

This scenario has changed over the past few years. More and more developers have realized the potential of this sector. The companies who had been doing this kind of development for their own use have also realized that the development skills they have acquired over the years are saleable. As a consequence today there are 30 different industrial parks being developed with an envisaged investment of Rs 93 billion.<sup>59</sup>

The surprising fact in these projects is that most of them are in partnership with the state governments. The state governments that earlier used to be high handed overlords of industrial development, are today competing with each other to attract investors to develop industrial space in their jurisdictions. This is a sea change from the days of the socialist beauracracy, the logic of free markets and economic growth has now been accepted by all sections of society. Thus one sees the Communist Party government of West Bengal being the most aggressive in terms of trying to attract private investments.

Given that the economic and industrial growth rates of the past few years are expected to continue in the near future, and the fact that the government is extremely open to foreign investments in this sector, there seems to be tremendous potential in industrial real estate.

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<sup>59</sup> Survey of Investment Projects, Center for Monitoring Indian Economy, May 1996

## Chapter Five

### *Summaries and Conclusions*

There is no doubt that India today presents an unparalleled investment opportunity for real estate investors. With all sectors of the economy growing at a fantastic pace, the demand base for different property types is expanding considerably. Real estate investors have made fantastic returns over the past few years and continue to do so today. Local developers work with a target level of expected returns in the range of 40 to 50 percent. Although there is no hard data available to support these numbers, the general opinion amongst the industry seems to support this view. Along with the huge price increases in the major cities, suburban developments are also on the rise and the smaller and medium sized cities are seeing large scale developments come on line.

The huge demand is primarily based on one of the fastest growing educated middle class societies' in the world, currently estimated at 200 million people, a growing domestic corporate & industrial sector, increased foreign investment and the advent of multinational companies. When compared to its competitors in the world markets for FDI, China, Brazil and Indonesia, India seems a much safer bet from an investment standpoint due to well protected property rights, a sophisticated financial system, tremendous demand base and an activity in the market which is not being witnessed in any other emerging market

Although the returns are extremely high, the markets also present a high degree of risk for the uninformed investor. They are very disorganized and lack the institutionality and transparency as witnessed elsewhere in the developed world. The demand-supply relationship is skewed due to highly constrained land and rent markets, lack of institutional financing, archaic and difficult regulations and an extremely painful construction process. Rapid urbanization, lack of infrastructural facilities and supply side shortages have led to sharp escalation in property prices all over the country. The supply side shortages have been a direct result of unimaginative and restrictive land, rent and tax laws governing the real estate sector. There is an ongoing initiative to bring about changes in these laws so as to create a free environment for real estate capital markets to develop. There is also increased transparency in the markets due to the entry of corporate developers, whose parent companies are publicly traded. They are used to working within the legal

structure and avoid any kind of underhand dealings that had become the hallmark of the real estate industry in India.

There are ongoing initiatives to develop the public markets for real estate. Real estate mutual funds and mortgage backed securities are expected to come into the market within the next two years. Securitization is seen as the answer to the prohibitively high costs of development. But this will require substantial changes in the mortgage foreclosure, property transfer and rent laws before it can become a reality, thus it may be a while before securitization sees the light of day.

There is also an increasing demand in the market for real estate service providers, especially from the multinational companies, who are used to a certain level of real estate facilities. At the same time Indian companies are getting aware of high quality real estate services and are demanding the same.

For any new investor going into the market it is extremely important to understand the legal and structural issues governing the sector and the impact that any changes in those laws would have on the real estate markets. Outlined below is a series of issues to be kept in mind by any investor wishing to invest in the Indian market:

1. The most important aspect to consider before entering the Indian market is to find a competent, honest, local joint venture partner. The market being so complex in the way it functions, it is essential to have a partner who understands the development process and the system and also has a fair track record in real estate. Though not an easy task it is definitely achievable as there are a number of developers with good track records working on high quality projects.
2. Design, project management and construction technology are the key areas where the foreign investors can fill in a void apart from bringing in the investments. All sections of the industry agree on the fact that the country needs severe improvements in these areas. The government is also more receptive to investment proposals that have a certain amount of value addition in them. Purely speculative real estate investments are not looked upon favorably by the government.

3. Given that the market represents a long term growth opportunity it is imperative for the investors to look at it from a growth oriented vision, instead of a shorter opportunistic, quick payback perspective. The government is also more receptive to longer term growth oriented investments.
4. In terms of property sectors there seems to be demand in all types, the maximum emphasis from the government's side being on hotels and industrial, followed by housing, with office and retail occupying the last place.
5. For a market the size of India it is very important to be on the ground, to fully understand the issues involved. Any sizable investment can not be controlled without having a local office.
6. In some of the areas the extremely high prices of land are a result of artificial scarcity and speculative fervor created by a few developers who control the land in that market. The foreign investors have to be extremely wary of these areas as any change in laws would lead to release of land into the market resulting in a crash of prices.
7. Finally, apart from hotels and infrastructure projects that are granted automatic approvals, the safest and the clearest legal avenue available for real estate investing, is to take approval from the foreign investment promotion board (FIPB). The OCB structure is not very transparent and clear, hence would probably make institutional investors uncomfortable. As clearances do not take a lot of time these days the FIPB approvals should be the most preferred avenue



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Appendix:		<i>Foreign Direct Invested Projects</i>		Rs 35 million = USD 1 million	
S. No.	Project / Location	Company- Indian / Foreign	Capacity	Capital Outlay (Rs. Million)	Project Status / Completion By
1	Five Star Hotel / Sahar-Greater Bombay	Bharat Hotels Ltd./ Hilton International	400 Rooms	1600.00	Dec-98
	The company has tied up with Hilton group for the project. The Ministry of Finance has cleared Bharat Hotels' Rs. 700 Million GDR issue which will be used to part fund the project.				
2	Five Star Hotel Project / Bombay	Marriott International	371 Rooms	1250.00	Dec-97
	The company has received FIPB approval to set up a 100% owned subsidiary				
3	Leela Palace Project / Greater Bombay	Leelaventure Ltd.-India/ Four Seasons/ Regent Group Canada	400 Rooms	1000.00	Feb-98
4	Five Star Hotel / Ludhiana	Khangura Holdings Ltd. / United Kingdom	134 Rooms	320.00	Apr-96
5	Five Star Hotel / Gandhinagar	Dadi Group- Singapore / Howard Johnson USA	91 Rooms	210.00	Jun-96

6	Three Star Hotel Expansion / Varanasi	Ideal Hotels - Foreign Ownership	From 40 to 100 rooms	85.00	Aug-96
7	Five Star Hotel cum Sports Complex / NOIDA (Suburb of Delhi)	Sterling Holiday Resorts (India) Ltd.		3500.00	Just Proposed
	The company proposes to make a GDR issue of Rs. 1400-1500 Million to part fund the project.				
8	Resort Hotel / Goa	Leela Scottish Lace Ltd. / Four Seasons / Regent Group USA	Villas 100 Nos.	1000.00	Just Proposed
9	Five Star Hotel / Bangalore	Leela Scottish Lace Ltd. / Four Seasons / Regent Group USA	300 Rooms	3000.00	Dec-98
10	Multi-Theme Haven / Nasik	Indo Global Biotec Ambience Ltd. / Atmarati France	100 Rooms	694.00	Just Proposed
11	Beach resort / Goa	Bharat Hotels Ltd. / Hilton International	250 Rooms	400.00	Just Proposed
	The company has tied up with Hilton group for the project. The Ministry of Finance has cleared Bharat Hotels' Rs. 700 million GDR issue which will be used to part fund the project.				

12	Shopping Mall / West Bengal	Agio Countertrade Pte. Singapore	250 Acres	5000.00	Announcement
	The company has signed an MoU with WBIDC (State govt. body). It will implement the project in collaboration with a shopping mall developer from USA.				
13	Hotel Cum Convention center / Delhi	India Trade Promotion Org. / Foreign Partner	1000 Rooms/ 5000 Seats	5000.00	Announcement
	The project envisages building a 1000 room hotel and 5000 seater convention center. ITPO is planning to float a global tender to execute the project on a build-operate-transfer basis. The management control of the complex will be handed over to the international partner.				
14	Hotel / Kerala	Kerala State Ind. Dev. Corpn. / Non Resident Indian		300.00	Announcement
15	Four Star Hotel / Calcutta	Hind Hotels International Ltd.- Foreign Owned			Announcement
	The company has signed an MoU with WBIDC				
16	Five Star Hotel / Madras	SPIC India / Carlson (Foreign)	150 Rooms		Announcement
17	Five Star Hotel / Golf Resort	Sterling Resorts India / Marriott International			Announced / MoU signed.

18	Information Technology Park / Bangalore	TATA Sons / Govt. of Karnatka / Singapore Economic Development Board	Mini Township	16000.00	Dec-98
The ITP is an integrated project consisting of Industrial, Office, Residential and Parking space. Nine Singapore investors are also participating in the project. the park will cater to electronics, computers and software industry. The contract for construction has been awarded.					
19	Hospital / Salt Lake Calcutta	Goenka group / Gleneagles International PTE. Ltd.	270 Beds	760.00	Jul-96
20	Hospital / Kerala	KSIDC / NRI	300 Beds	180.00	Under Implementation
21	Hospital / Calcutta	Agio Countertrade Pte. Singapore	Medical Services	1000.00	Proposed
The company has signed an MoU with WBIDC					
22	Water Amusement Park / Jaipur	Rajasthan State Govt. / White Water Co. Canada		110.00	Proposed

23	Industrial Park / Maharashtra	Greaves India (Thapar Group) / MIDC (State Govt.) / SICOM Singapore	900 Hectares in Ist phase / 1400 hectares in IInd phase	35000.00	Announced
The project has received in principal clearance from the FIPB. Feasibility report was to be completed in Oct. 1995. Of the total 26 % to be invested by the state govt. and the rest by Greaves and the Singapore company.					
24	Hardware Technology Park / Gurgaon, Haryana	Unitech Ltd. India / HUDA ( State Govt) / First Capital Corpn. Singapore / Parameswara Holdings, Singapore		2200.00	Announced
25	Hospital / Calcutta	Medi Projects India / Agio Countertrade PTE. Singapore	250 Beds	350.00	Announced
26	Five Star Hotel / Bombay	Godrej India / Portman Developers USA / International Equity Partners USA	Mixed use project		Announcement

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27	Industrial Model Township	Government of Haryana / Mitsui, Mitsubishi, Marubeni Japan	Integrated township	Announcement
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The Japanese government has decided to allocate 2,658 million yen for the project. The consortium of Japanese companies will do the feasibility studies and project planning. The township envisages infrastructure facilities including a captive power plant, transportation centers, residential, commercial, recreational and exhibition space. The National Capital region board has agreed to provide a loan of Rs 1.125 billion for the project.

			Total	78959.00
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Source: Survey of Investment Projects, May 1996, Center for Monitoring Indian Economy and Author's Research



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